Revisiting the Winners' Game

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During the past few years, investment professionals have been accused of violating their fiduciary duties and providing subpar performance in exchange for costly fees. Yet, many investment professionals are careful stewards of client assets. They are defined by four elements that serve as benchmarks for industry best practices. Investors can regain confidence in advisers and the industry by asking five key questions to identify such stewards.

Investment professionals have been subjected to some sensational allegations over the past few years. Among the most serious is that they all are complicit in breaching fiduciary duties to clients. The good news is that there is a way to defend the innocent in the industry against these charges. I am not providing a complete case for the defense, but I hope that the elements of my argument might be useful to investment firms in practice and in their communications with clients. I also implore all investment professionals to encourage a jury of the investing public to ask the right questions so that they are able to recognize the stewards in the industry—those advisers who have taken heed of the most important aspects of the client relationship.

One of my heroes is Charles Ellis, who wrote *Winning the Loser's Game*.[1] It is the seminal work on how to approach investing from a risk management point of view. During the past two years, Ellis has prosecuted a vigorous case against all investment professionals, most specifically in two articles written for the *Financial Analysts Journal*. In "Murder on the Orient Express: The Mystery of Underperformance," Ellis accuses investment managers, consultants, advisers, and those who purport to be fiduciaries of complicity in the extensive crime of underperformance.[2] In "The Winners' Game," Ellis alleges that the business motives of the investment industry have caused its members to lose sight of their fiduciary duty to clients.[3]

I think CFA Institute CEO John Rogers recognizes the responsibility of the profession to face up to the charges Ellis has levied against it when he writes the following:

> I believe that the next generation of leaders in finance will be defined not by the amount of money they can amass, but by the stewardship they exercise as fiduciaries and the responsibility that they demonstrate to their communities.[4]

Rogers highlights the importance of stewardship in the coming generation of leaders in finance. I propose that the way to win the winners' game is to be a good steward, and I believe that there are stewards in the investment industry today who have been playing the winners' game all along.

To substantiate that point, I will identify and define four elements that stewards can apply in responding to Ellis's charges and Rogers's challenge. I think my case for the defense also frames five questions that a jury of the investing public can use to identify such stewards.

Four Elements of Good Stewardship

The first element of being a good steward is defining the client's mission correctly. In "The Winners' Game," Ellis defines the mission as generating absolute returns. I contend it is more than that. Correctly defining the mission is also about counseling a

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[1]Charles Ellis, *Winning the Loser's Game: Timeless Strategies for Successful Investing*, 5th ed. (New York: McGraw-Hill, 2009).

[2]Charles Ellis, "Murder on the Orient Express: The Mystery of Underperformance," *Financial Analysts Journal*, vol. 68, no. 4 (July/August 2012):13–19.

[3]Charles Ellis, "The Winners' Game," *Financial Analysts Journal*, vol. 67, no. 4 (July/August 2011):11–17.

[4]John D. Rogers, "Getting America to Trust Wall Street Again," CNBC, *Guest Blog* (11 Apr 2012): www.cnbc.com/id/47017022/Rogers_Getting_America_to_Trust_Wall_Street_Again.

client on what investment goals are realistically possible from that client's starting point.

The second element is to smooth the ride to the destination. Smoothing investment returns is a critically important part of stewarding assets on behalf of clients and one that is all too often neglected in the investment industry.

Third, stewards manage expectations down to what is realistically possible rather than telling clients everything is possible. There is no need to resort to complicated financial engineering to reach for returns and yield that are not possible without assuming undue risk.

Fourth, stewards emphasize cost containment. Benjamin Franklin said that nothing is certain except death and taxes. In investments, only one thing is certain: costs. Advice should not be given to clients without full disclosure on costs and their containment.

Stewards that play the winners' game typically emphasize at least one, if not all, of these four areas in their investment processes and communications.

I will now discuss how each of these four elements can be used by industry participants to restore credibility to the profession and then offer five questions the investing public should ask to identify industry stewards that are playing the winners' game.

Define the Client's Mission

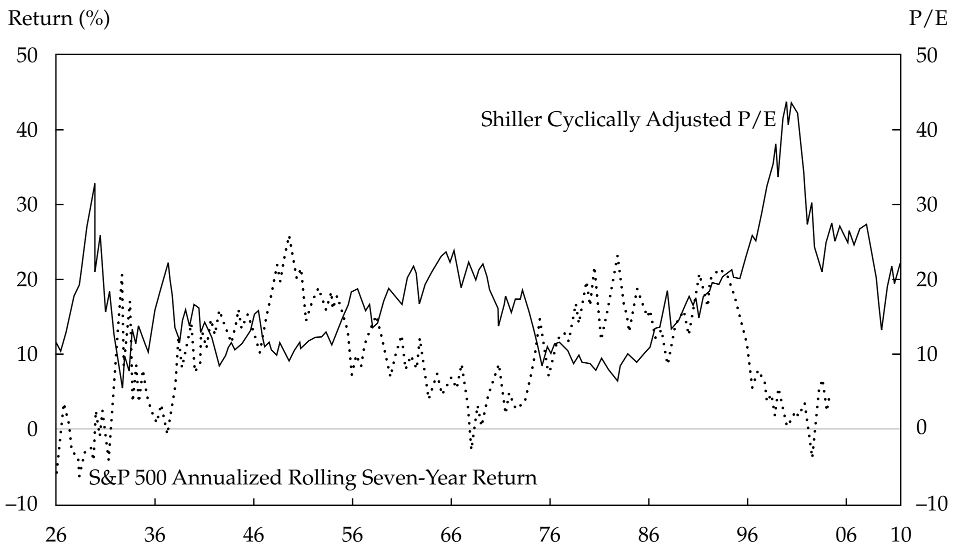
Yale economics professor and author of *Irrational Exuberance* Robert J. Shiller has built a widely respected career in both academia and applied finance by making one profound point: The starting point, or price of an asset relative to underlying fundamentals, is a key determinant in assessing prospective returns of the asset.[5] **Figure 1** depicts Shiller's favorite long-term measure of value, the cyclically adjusted P/E, which he defines as the multiple of the S&P 500 Index smoothed over a period of time, typically 10 years, and adjusted for inflation. The figure shows the Shiller P/E from 1926 to the end of 2010 along with the annualized rolling seven-year return lagged seven years for the S&P 500. The two series exhibit a correlation of –0.59.

It is possible to analyze this relationship in more depth by comparing the Shiller P/E with its long-run average, thus improving its forecasting power, but investors remain mesmerized by short-term returns: What will the market be doing next week, at the end of the year, or even at the end of the next three years? An investor who looks at such long-term measures of fundamental value can be quite precise about future returns.

In response to Ellis's advice to invest for absolute returns, I contend that correctly defining a client's mission consists of counseling that client about the horizon required to garner the desired absolute returns. As Figure 1 shows, there have been periods when, on a rolling seven-year basis, equity returns have been negative. The fact that the last decade has generated relatively poor returns for equity markets should not be that surprising.

[5]Robert J. Shiller, *Irrational Exuberance*, 2nd ed. (New York: Crown Business, 2006).

Figure 1. Shiller Cyclically Adjusted P/E and S&P 500 Annualized Rolling Seven-Year Return, 1926–2010



Note: The S&P 500 return is lagged seven years.

Source: Based on data available at www.econ.yale.edu/~shiller/data.htm.

As shown by this type of analysis, equities were simply not priced to generate absolute returns a decade ago. Evaluating the starting point is essential when defining the client's mission. Given that today the Shiller P/E is higher than its historical average, it is not realistic to expect U.S. equities to deliver above-average prospective rates of return over the next seven years, although 7% may be possible on a global basis.

Forecasting returns based on the starting point comes with a lower standard error in fixed-income markets. **Figure 2** compares the Barclays Capital U.S. Aggregate Bond Index's yield with rolling seven-year returns lagged seven years for 1976–2010. If one assumes no change in the shape of the yield curve, the future rates of return can be projected with quite a high degree of certainty by the index's starting yield. Today, that projected return is roughly 2.5%.

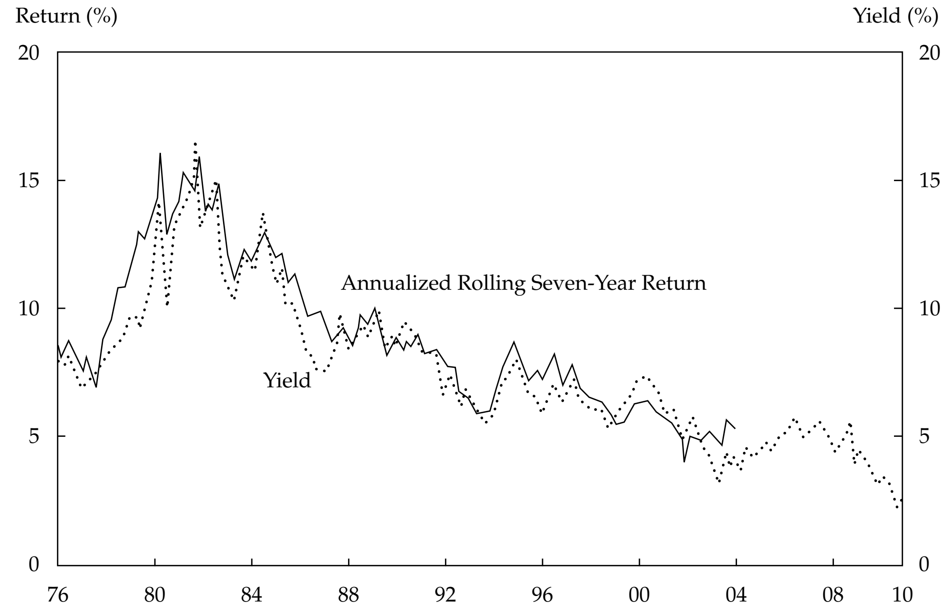
These two illustrations highlight how dangerous the common practice is of defining the mission by a portfolio of 60% stocks and 40% bonds—a so-called balanced, diversified portfolio. **Figure 3** shows the simulated projected values over 20 years of $10 million invested today in such a "60/40" portfolio. It assumes that over the next seven years, equities return no more than 7%, bonds return no more than 2.5%, and inflation averages about 3.25% annually. Consider the impact of these assumptions on a foundation that relies on this portfolio for spending. With a 5% spending goal, the best that foundation can do in today's environment with this portfolio is to invade capital in real terms at a slower rate, as shown by the best-case line. In a world of financial repression, in which future returns on stock and bond markets are most likely to be below average, nothing defines the investment industry's challenges today better than the projection presented in Figure 3.

The bottom line is stewards form expectations based on their views of expected absolute returns, devoting a lot of effort to defining the mission correctly and determining how long the journey to the destination is likely to take. They know that investing is not a relative game and that just because traditional bonds look like a terrible long-term investment today, it does not mean that stocks will necessarily be a great investment. Stewards work to bridge the gap between what is possible and what is required in other ways. The mission is not to beat the market every week or every quarter or even every year. Short-term relative returns are almost incompatible with long-term absolute returns based on what is possible from today's starting point.

Smooth the Ride to the Destination

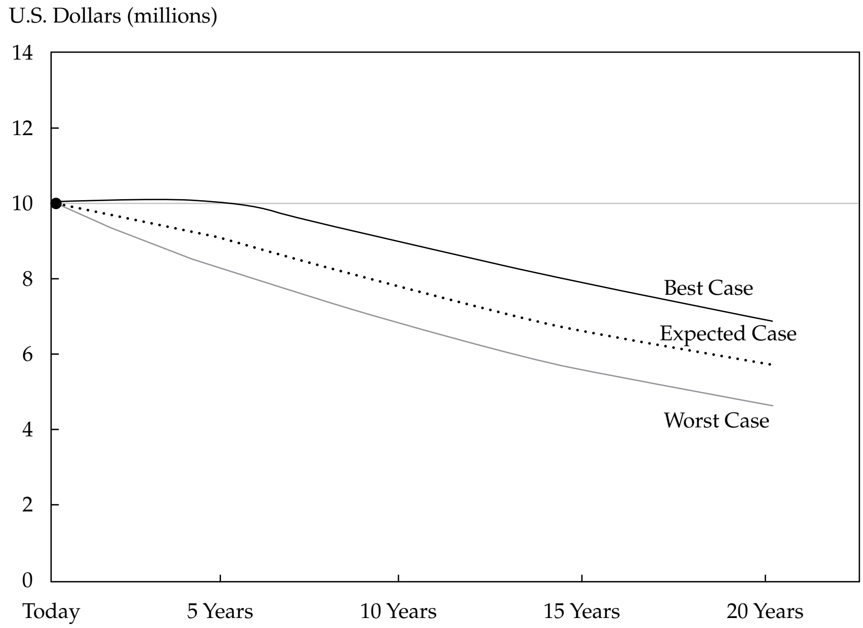
George Soros, a business magnate, investor, and philanthropist, has famously said that it is not whether you are right or wrong that is important but how much money you make when you are right and how much you lose when you are wrong. Smoothing the ride to the destination matters for

Figure 2. Barclays Capital Aggregate Bond Index Yield and Annualized Rolling Seven-Year Return, 1976–2010



Note: The seven-year return is lagged seven years.

Figure 3. Projected Inflation-Adjusted Values of $10 Million Invested in a 60/40 Portfolio over 20 Years



Notes: Assumptions are that equities return no more than 7%, bonds return no more than 2.5%, inflation averages about 3.25% annually, and there are annual withdrawals of 5%.

two reasons. First, volatile journeys to the destination lead to destructive behavioral biases along the way. Second, portfolios compound at geometric rates of return, not arithmetic rates of return. Lower volatility and a smoother ride to the destination—the ability to manage upside versus downside capture—are thus extremely important to stewards.

To illustrate how behavioral biases can affect investment decisions, consider the following two scenarios.[6]

In the first scenario, investors can choose either Option A, which has an 80% chance of a $4,000 payoff and a 20% chance of zero payoff, or Option B, which has a certain payoff of $3,000. In a random survey, 80% of people select Option B even though Option A has an expected value of $3,200 (80% × $4,000 + 20% × $0 = $3,200) compared with Option B's value of $3,000.

In the second scenario, investors can choose either Option A, which has an 80% chance of a $4,000 loss and a 20% chance of zero loss, or Option B, which has a guaranteed loss of $3,000. The majority of individuals choose Option A even though its expected loss of $3,200 (80% × –$4,000 + 20% × $0 = –$3,200) is greater than Option B's negative value of $3,000.

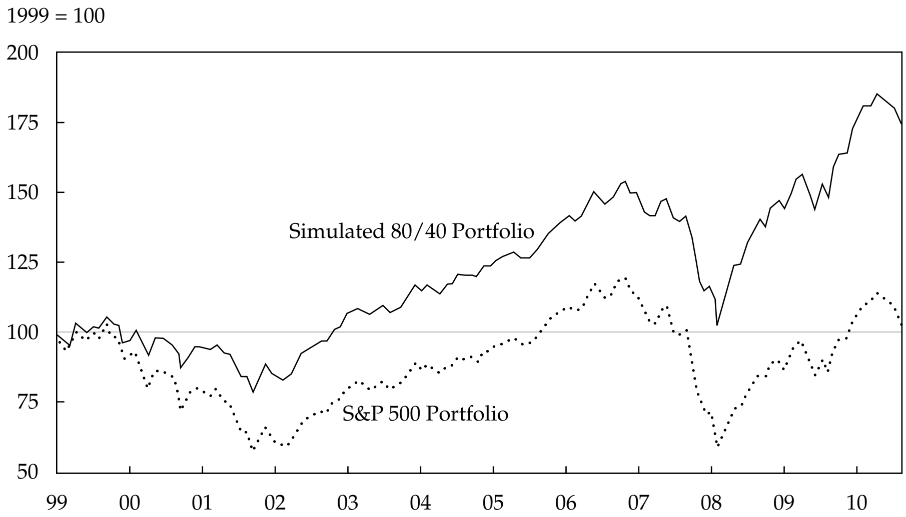
[6]I first came across this thought experiment in Lewis A. Sanders's keynote speech, "Providing Effective Investment Advice, Insights from Behavioral Finance," given at the 2005 Morningstar Investment Conference.

These choices demonstrate that investors are risk averse on the way up and risk inclined on the way down. The average individual will take more risk to avoid losses than to capture upside. Investors that monitor volatility on a daily basis have the tendency to cut losers or sell winners too quickly. By smoothing the ride to the destination, it not only allows compounding to work over time, but it can also minimize such potentially negative behavioral biases.

Figure 4, which shows the value of a portfolio invested in the S&P 500 from 1999 to 2011, especially illustrates the value of managing downside capture. Note that this sample period covers the "lost decade" of stock market investing in which the S&P 500 ended up at about the same place it started after exhibiting significant volatility along the way.

Over this time period, we constructed a simulated portfolio that never outperformed the S&P 500 in a month when the index was up. This portfolio captured 80% of the index's upside but only 40% of the index's downside. The long-term performance impact of managing downside capture in a portfolio rather than trying to beat the index is stunning, regardless of the sample period used. Performance reports often fail to emphasize this profound point. Portfolios compound geometrically, not arithmetically; the difference between the two is excess volatility. To identify stewards, look at their performance reports to determine whether they are emphasizing upside versus downside

Figure 4. Value of a Portfolio Invested in the S&P 500 and a Simulated 80/40 Portfolio, 1999–2011



capture. Unfortunately, teaching clients to understand the importance of smoothing the journey is difficult. The short-term relative return, "what have you done for me lately" mentality remains pervasive in the investment industry.

For those who are cynical about the ability of the jury of the investing public to appreciate this point, I recommend reviewing the performance track record of everybody's investment folk hero, Warren Buffett.[7] When we compare the returns for Berkshire Hathaway and the S&P 500 from 1989 to 2011, the difference between the two is astonishing. The average monthly positive return for the S&P 500 was 3.4%; for Berkshire Hathaway for those same months, it was 3.0%. On average, when the S&P 500 was up, Berkshire Hathaway stock underperformed the index. But when the average monthly index return was negative, it was –3.6% for the S&P 500 but only –1.5% for Berkshire Hathaway. Over the long term, by reducing downside capture, it translated into total returns of 649% for the S&P 500 and 2,342% for Berkshire Hathaway, which comes to an annualized return of 9.2% for the S&P 500 versus 14.9% for Berkshire Hathaway. Why do so few investors exhibit a willingness to explicitly give up some upside during positive markets to more than mitigate the downside during negative periods if the effects of compounding are so obviously powerful in both directions?

Managing the journey to the destination, I hope you will now agree, matters tremendously. Rather than trying to define every twist and turn in the economy or the market over the next week or year, stewards spend a lot of time controlling the amount of risk they take and managing their upside/downside capture ratio.

Manage Expectations

Managing expectations is an element about which I am passionate. For example, some industry participants predict that risk parity will be the new paradigm in asset allocation and that asset class definitions are now obsolete. Good stewards will counsel clients on what types of returns are possible rather than try to engineer a complicated but potentially unsustainable escape route from the harsh reality of today's starting point. I believe there is some value in elements of the risk parity approach, but risk parity is not a panacea for a decade of frustrating returns in equity markets.

The risk parity approach that many investors practice today is often based on borrowing money to leverage safe asset classes to a risk level equivalent to equities so the portfolio does not have to rely on the equity risk premium for growth. That approach has worked exceedingly well over the past two years as the Federal Reserve has driven down interest rates. The valuable insight risk parity offers is that portfolio diversification can be much more efficient if asset classes are grouped by common risk metrics, such as by a credit risk premium, an equity risk premium, or an interest rate risk premium. But a more robust answer to today's challenges is not simply to borrow a lot of money to invest in long-duration assets in an attempt to generate returns that are not possible from today's starting point.

[7]Lattice Strategies, "The Oracle of … Risk Management? A Key Driver of Warren Buffett's Success," *Real World Risk Management*, vol. 1 (Q4 2010).

Balentine's approach is to group asset classes by common risk metrics using a building-block approach, in which assets are diversified by common risk and liquidity properties rather than by conventional asset classes. We explain to clients that risk is not just volatility, and we show them how a diversified investment program can be built through exposures to each of five building blocks—liquid reserves, safe assets, market risk, manager skill, and private capital. Separating liquidity and safety from risk in all of its guises is not only a more efficient way to diversify portfolios, but it also helps clients manage expectations to what is realistically possible. Our framework is not the only way to drive this conversation.

Emphasize Cost Containment

Some of the most condemning evidence against the investment industry and active management is shown in **Table 1**. It shows the percentage of all funds in each category (asset class) that outperformed that category's index over five years ending 2011. The conclusion is that passively managed index products outperform active managers in a variety of asset classes. I do not take sides in what I view as a highly partisan debate between proponents of only indexation and proponents of only active management. The truth, as always, lies somewhere in between these two extremes and requires a more subtle analysis of the data. But as Table 1 clearly shows, the choice of implementation vehicle must include an explicit consideration of costs.

Thoughtful stewards have developed sophisticated opinions about active versus passive management that are not dogmatic but focus on cost versus expected benefits. They spend a lot of time trying to understand when active management does better than passive management—not just across asset classes but also over time. They know that adopting a passively managed approach in certain areas can add value over time without sacrificing performance. To help bridge the gap between the outcomes that are possible and those that are required, my firm, for example, focuses a great deal of attention on rebalancing asset allocations to public markets by using index funds, which are cheap, liquid, and transparent, as well as tax-efficient instruments for the taxable client. This approach saves our clients' implementation fees for strategies in more inefficient areas in which uncorrelated active management has a greater chance of delivering successful outcomes. If rebalancing passive investments is done judiciously rather than as a market-timing exercise, advisers can add a great deal of risk-adjusted value to a portfolio over time. An adviser will not give up performance by implementing a passively managed approach to contain costs.

Table 1. Percentage of Funds in Each Category that Outperformed the Category's Index over Five Years Ending 2011

Category	Percentage that Outperformed Index
All domestic stocks	38.12
U.S. bonds (long term)	6.38
High-yield bonds	3.94
Municipal bonds	9.76
International stocks	22.02
Emerging market stocks	17.11

Source: Based on data from S&P Indices Versus Active Funds (SPIVA) Scorecard, year-end 2011.

Related to this view, one charge many industry participants are guilty of is the inability to talk to clients transparently and accurately about all-in fees. It is frustrating to come across prospective clients who are comparing apples with oranges, which is exacerbated by an industry that has continually confused clients about which fees they are paying for which service. They often do not know whether a fee is being paid for advice, implementation, or product.

The following fees are typically not clearly defined:

- Advisory fees—the fees that clients pay for investment management and counseling;
- Transaction fees—costs emanating from trades and commissions;
- Fees for "house" products—special incentives an adviser may receive by offering a proprietary product;
- Reporting and analysis fees—additional fees that are sometimes charged for performance reporting or other analyses;
- Manager search fees—separate fees, often charged by consultants, to provide due diligence on third-party managers; and
- Bonus/incentive fees—additional fees that managers may charge once certain performance objectives are met.

Beyond combining both passive and active approaches, good stewards talk to clients not only about the level of fees but also about the structure of fees to ensure that such "hidden" costs are disclosed. Furthermore, stewards put a great deal of effort into advocating on behalf of clients for lower implementation costs. There are many ways to address the level and transparency of fees and the incentives created by different fee structures. Failing to talk to clients about fees is inexcusable.

Five Essential Questions

Unlike Ellis, I believe that some firms have reconciled their legitimate profit motives with their fiduciary duties and answered Rogers's call for fiduciary responsibility and good stewardship. The way to recognize those firms is to look for the four elements I have just described. The firms that have developed thoughtful approaches along these lines are playing the winners' game.

To identify the stewards of the industry that are playing the winners' game, I recommend the investing public thus ask advisers the following five questions and look for some specific answers:

1. *What is your definition of risk, and do you maintain an allocation to every asset class when constructing portfolios?*

   Instead of asking advisers where the economy is going, what returns to expect next week or next year, or how to define the mission relative to a short-term benchmark, clients should ask advisers how they define risk and long-term returns. Does the adviser define risk as failing to beat the market or failing to generate absolute returns? Clients should also ask what time period is needed to generate absolute returns and how their journey to the destination can be smoothed to avoid permanently impairing capital. Does the adviser start from a point of explaining what can go wrong with a recommendation rather than what will hopefully go right?

2. *What elements of your performance reporting do you emphasize, and can you attribute returns by decision?*

   Performance reporting and what it focuses on is a key way to identify stewards. Remember how powerful it is to harness the power of compounding by increasing the spread between upside and downside capture.

3. *How often have you managed expectations by telling clients that their investment objectives are not possible?*

   We spend most of our time with our endowment and foundation clients talking down the rate of spending they think they can achieve in today's environment. This type of dialogue is the right answer to the challenges of meeting objectives based on today's starting point. Beware of the complicated engineering that often involves borrowing money to buy bonds to hopefully return 15% over the next year and spend at 5%, all the while hoping that interest rates do not rise.

4. *How and when do you rebalance a portfolio?*

   Asset allocation needs to be dynamic in today's environment to bridge the gap between what is possible and what is required.

5. *Do you have a view on the use and type of index funds and how do you get paid?*

   My investment staff has found that spending time around the due diligence of index funds has already paid handsome dividends. Passive management requires active due diligence. A tremendous amount of value can be added, not just in the strategy designed for a client but also in how index funds are selected to execute that strategy. I think stewards and winners are already following that particular trend. Remember to compare apples with apples, not with oranges, when exploring the fee structure of an adviser and whether it is aligned with your interests.

Conclusion

The genesis of my talk today was my genuine disappointment at learning that Charles Ellis, an admired observer of our industry, felt the need to challenge investment professionals to play the winners' game and fulfill their duties as fiduciary stewards. My response is that some firms have been playing the winners' game all along. I recommend four ways to recognize such firms and five questions that the industry should encourage clients to ask so that they can also identify good stewards and regain some of the confidence lost in the industry since the 2008–09 financial crisis.

This article qualifies for 0.5 CE credit, inclusive of 0.5 SER credit.

Question and Answer Session

Adrian Cronje, CFA

Question: How do you diversify portfolios by risk factor, and how do you report risk-factor diversification to clients?

Cronje: We group asset classes by common drivers of returns and risks. We also take their volatility and liquidity properties into account. For example, instead of using the moniker "fixed income," which could include high-yield bonds, emerging market debt, Treasuries, and/or municipals, we decompose the typical fixed-income universe and identify a "safe" asset building block defined by asset classes whose returns are clearly driven by duration, credit risk, and inflation risk.

Then, we examine currency risk, which is extremely important today because of our home bias in the United States. Given their starting yields, a thoughtful allocation to global bonds in the area of safe assets can go a long way for an endowment or foundation with spending needs of 5%. Those four drivers of risk tend to put asset classes in the "safe" category, which provides a potential shock-absorbing role in a portfolio.

Next, we evaluate the volatility of the assets. We analyze historical data and rolling volatility. We find that high-yield bonds and emerging market bonds have volatility closer to market risk and global equities than to fixed income, so we compare high-yield bonds with equities. High-yield bonds are driven by corporate profits much like stocks are.

A key point is that this process is dynamic. For instance, emerging market bonds used to have equity-like volatility, but their volatility levels have slowly trended lower and may be eventually approaching those of Treasury bonds and municipal bonds, which, in turn, have started to trend higher.

Reporting risk-factor diversification is difficult. Few firms have the capability to do it, and the performance reporting industry has not received enough demand to respond to such needs for customization, although I believe that is changing. We work with a firm that has the technology to classify asset classes by risk- and liquidity-based building blocks, so we can clearly show clients to what and for how long we have deployed their capital.

Our clients can view their portfolios based on allocations to liquid reserves, safe assets, market risk, active manager skill (including hedge funds), and private capital, rather than simply viewing a list of funds and returns. We can have discussions with clients about expected absolute returns given their liquidity risk, volatility and drawdown risk, and exposure in terms of these underlying drivers by asset classes. Many pension funds are starting to diversify portfolios using such groups of asset classes.

Question: Is there a barrier to entry in terms of client acceptance of an approach based on risk-factor diversification and asset allocation?

Cronje: The barrier to entry is surprisingly low when we are able to present this approach directly to clients ourselves, but the barrier to entry is high when there is an intermediary between our firm and the client, such as a consultant. Frankly, the consultant business model is in certain cases an impediment to gaining client acceptance for new ways of thinking about asset allocation.

When we are able to talk with clients directly about the roles of these building blocks—for example, safe assets as shock absorbers—clients find the approach intuitively appealing, and it allows us to explain more clearly the decisions we make. For example, we have developed an understanding with our clients about how "worn out" today's traditional shock absorbers are based on how low yields are. So the need to diversify fixed-income assets away from nominal, domestic core bonds is paramount.

Similarly, the role of market risk is to capture upside returns that are available from global stock markets over time by rebalancing equity-like asset class exposure, not to try to beat the market every week. We separate this beta component from the alpha component of strategies. This approach forces a view on how portfolios should be rebalanced, and it forces discipline regarding fees. Clients would rather save fees for alpha in the form of active manager skill.

Question: What are the benefits to this asset allocation approach in the form of tax management for taxable clients?

Cronje: The building-block foundation sets up nicely for a tax-efficient approach. There are a plethora of passive vehicles within the areas of safe assets and market risk to obtain beta exposure. These passive or low-cost active vehicles are typically more tax efficient than hiring traditional active managers to implement exposure to bonds and stocks, so clients get the double benefit of lower fees and lower expected taxes.

Some innovative strategies can also be implemented. For example, if a firm's clients have enough money or the firm is able to commingle client assets, it can hire a subadviser to replicate an index with a more aggressive tax-loss harvesting strategy. There are many firms that can add such value when more active tax-management strategies are needed.

Question: How might the asset management business change if the Fed's policy of zero interest rate continues for the foreseeable future?

Cronje: Our industry has already changed because of the prolonged effects of this policy. Whether our clients are seeking market risk or even private capital, their first concern now is how much yield they can get. Mindless yield-chasing behavior across all asset classes could become a serious concern. For two years, the largest flows among asset classes have been from cash into high-yield bonds.

Allocating and constructing a strategy that has a diversified and sustainable yield is an extremely important macro trend as a result of financial repression, particularly as the first cohort of Baby Boomers begins to retire over the next five years and will need to live off their assets.

Question: Is it possible to construct and manage a portfolio in today's environment that captures 80% of the market upside and 40% of the market downside?

Cronje: It is difficult. A recent paper explains how Buffett was able to capture Berkshire Hathaway's 80/40 by using float and leverage to buy low risk, high-quality, and safe stocks.[8] The only way one can achieve an 80/40 result is to be very contrarian and highly active. But the math still works favorably if the spread between the upside and the downside capture of a portfolio is increased, so we focus on that.

Even by capturing 60% of the upside and 45% of the downside, the portfolio's path to the destination benefits from smoothing. I would argue that by thoughtfully constructing a portfolio according to risk-based building blocks, rebalancing beta, and engaging highly active managers to separate beta from alpha, advisers can meaningfully increase the spread to get clients to where they need to be.

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[8]Andrea Frazzini, David Kabiller, and Lasse H. Pederson, "Buffet's Alpha," Yale Department of Economics (29 August 2012).