

# The Policy Portfolio in an Era of Subdued Returns

By

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Before

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and

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Today, I'd like to talk to you about the role of the policy portfolio—the portfolio that reflects the long-term views of its trustees and advisers about expected risks and returns in the various asset classes—in the coming era of subdued returns in the financial markets. To do so, I'll begin by taking you briefly through the investment methodology that leads me to that conclusion. The merit of this approach is that it concerns itself, *not* with the historical returns realized in the markets, but with the very roots whence sprung those returns. In using this methodology, I am merely putting numbers to what John Maynard Keynes described as *enterprise*—“forecasting the prospective yield of assets over their entire life”—and *speculation*—“forecasting the psychology of the market.”

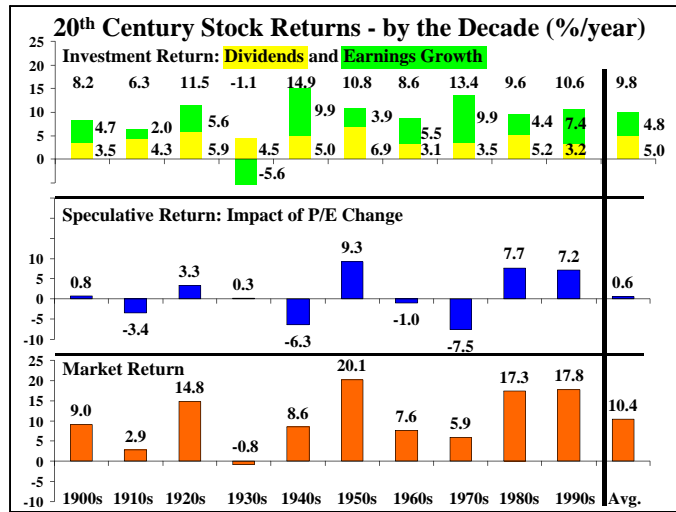
One of history's wisest investors, Lord Keynes warned us that, “it is dangerous to apply to the future inductive arguments based on past experience, *unless one can distinguish the broad reasons why past experience was what it was.*” It turns out there are just two reasons that explain stock market returns. One is *Investment Return* (what Keynes called “enterprise”), the initial dividend yield on stocks plus the subsequent annual earnings growth. The other is *Speculative Return* (Keynes' “speculation”), the annualized impact of any change in the market's price-earnings ratio. (If the P/E rises from 15 to 20 times over ten years—a 33% increase—it will add 2.9 percentage points to the annual investment return.<sup>1</sup>)

## Returns Through the Decades

If we examine each of the decades of the twentieth century, for example, we'll see that the average starting dividend yield on U.S. stocks was 5.0% and the average annual earnings growth was 4.8% for an investment return of 9.8%. On average, the P/E began each decade at 12.5 times and ended at 13.3 times, adding a speculative return of 0.6% to the investment return. Total stock market return: 10.4%. These figures prove something we all know intuitively: In the long run, when the emotions of speculation inevitably dissolve, it is the economics of enterprise that drive stock market returns.

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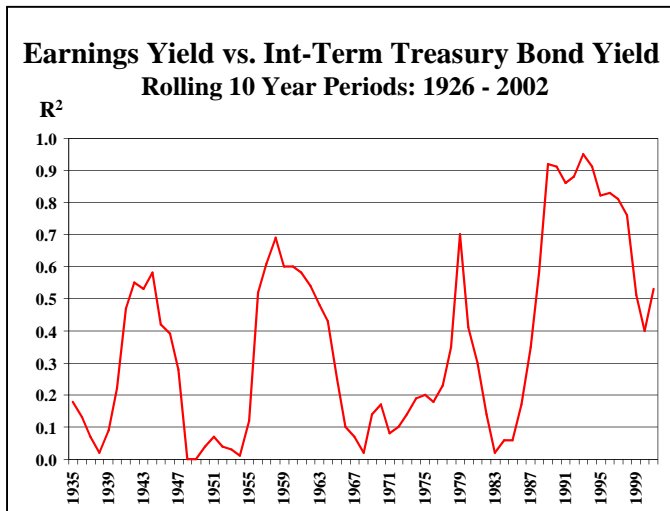
<sup>1</sup> Actually, one should multiply the two, but it doesn't matter very much (i.e., an 8% investment return plus a 3% speculative return equals 11%, while 1.08 times 1.03 equals 1.1124). So I favor the simplicity of addition.



Not that there weren't periods—sometimes rather long—that challenged this thesis, and challenged it both ways. During the decade of the 1970s, for example, corporate earnings growth was 9.9%, tied with the 1940s as the *highest* decade for earnings growth in the century. The dividend yield added 3½% for an annual investment return of 13.4%, topped only by the 1940s, and nearly 40%(!) above the norm. The annual speculative return, however, was the *lowest* of the period, a negative 7.5% per year, as the P/E tumbled 60%, from 16 to seven times.

There's a lot of reversion to the mean (RTM) in price-earnings ratios, rarely more so than in the decade of the 1980s that immediately followed. Then, the P/E more than doubled to 15 times, a *positive* speculative return of 7.7%, which, when added to the 9.6% investment return, gave us our 17.3% total market return for the 1980s. Amazingly, as the 1990s began, the market was about to provide almost the identical performance, and with almost the identical ingredients—investment return for the decade, 10.6%; speculative return, 7.2%; total return, 17.8%. But after two consecutive decades of returns unparalleled in all financial history, driven by a 4½-fold increase in the RTM-sensitive P/E ratio to nearly 31 times as 1999 ended, we shouldn't have been surprised that the outlook was for far lower returns during the coming decade ending in 2009.

This simple reliance on the P/E ratio of course, ignores the level of interest rates. While it's alleged, that, say, lower rates justify lower earnings yields (i.e., higher P/Es), the long-term annual correlation (since 1926) is a rather pathetic 0.004. While on a decade-long basis the correlation (actually, the R-squared) rises to 0.36, the range is astonishing—more than 0.90 in the decades ending in the early 1990s, below 0.20 in the eleven decades ending from 1966 through 1976, and little above zero in almost 15 periods. This erratic relationship persuades me to leave well enough alone and makes no adjustment for interest rates.

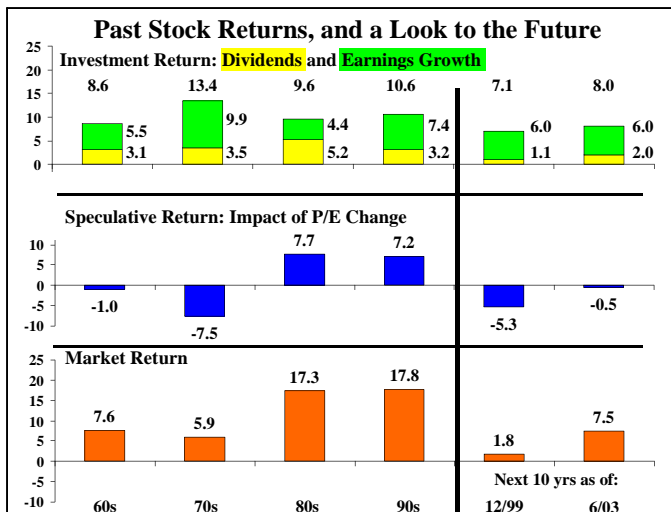


### Looking Ahead as 2000 Began

In any event, as 2000 began, the 1.8% return on stocks that I projected for the coming decade would have been, with the exception of the 1930s, the lowest for any preceding decade. The analysis wasn't complicated. Dividend yield was a skinny 1.1%, and a far cry from the 5% long-term norm. I guessed that annual earnings growth might average 6%, optimistic by long-term standards but consistent with the post World-War II era. *Investment* return then, 7.1%. I couldn't imagine that the P/E of 31 times would rise, and guessed it might drop to 18—who on earth *knew* how far it would drop?—providing a negative speculative return of -5.3%.

The resultant total annual return of 1.8% for the first decade of the new century, I was certain, wouldn't result from ten years of 2% annual returns. *Markets just don't work that way*. Rather, I told audiences that more likely would be a decline of 40% to 50% somewhere along the way, surrounded by a bunch of "normal" years, up and down, averaging around 8%. We've now had that decline—actually just short of 50%—with the S&P 500 tumbling from 1527 in the spring of 2000 to 775 at last October's low.

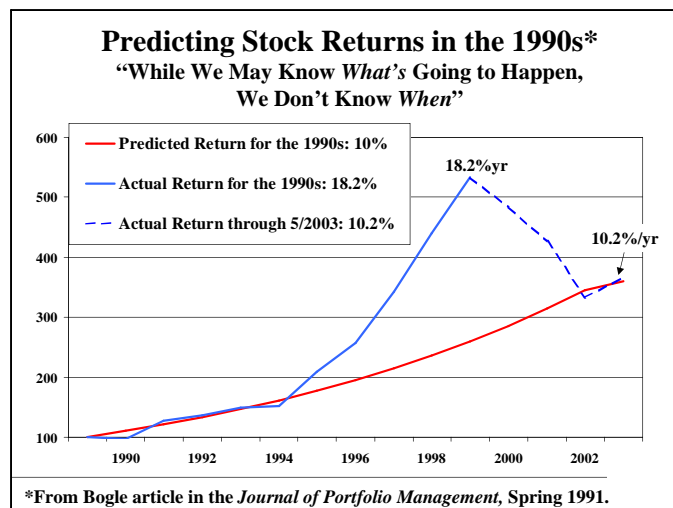
Today, off a solid 25% rebound from that low, the S&P 500 is at 985 with the dividend yield now at 2.0%, plus a still-expected (hoped-for?) 6% earnings growth, the investment return on stocks during the coming decade would be 8%. The P/E has risen to about 19 times on projected operating earnings (I know that's a stretch) and it's hard to see much upside. If we assume it eases the 18 times ten years from now, speculative return would take away about one-half a point from the investment return. Result: Reasonable expectations suggest to me an annual return on stocks of about 7½%—say, 6% to 9%—in the decade that lies ahead. (You don't agree? Just to insert your own expectations for earnings growth and P/E change, and then extend the simple math.)



### Timing is Everything

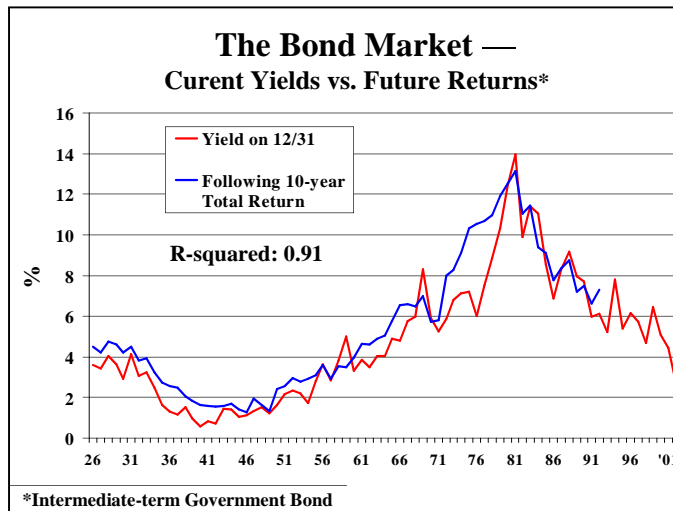
The success of market projections, of course, depends on the accuracy of the numbers we put into each slot. But the analysis is not only logical. It *works*, although it sometimes takes a while. For even though we have absolutely no idea of *when* it's going to happen, we have a pretty good idea of *what* is going to happen in the stock market. No one is more aware of the fallibility of timing than am I. As the 1990s began, I had the temerity to forecast, in an article in *The Journal of Portfolio Management*, the returns on stocks for the coming decade. Using essentially the same simple formula I've described here, I concluded: "during the 1990s stocks will have their work cut out for themselves to exceed returns in the 8% to 12% range, during the 1990s, perhaps averaging 10% annually."

What a forecast! The actual stock market return during the 1990s was 18.2%! Happily, my article acknowledged that the return could be "just like the 1980s"—17.5%—if we assumed aggressive earnings growth and "unusually optimistic sentiment," although such a "substantial overvaluation (however, would likely be) corrected by a market decline." Nonetheless, I was appropriately needed for my "system." Yet by mid-2003, just three and one-half years later, the stock market's cumulative annual return since January 1, 1990, had come down to 10.2%. So my 10% central projection was, if 3 years off, surely "close enough for government work." If there is a better example of knowing *what* will happen in the market, but not knowing *when*, someone will have to tell me about it.



## What About Bonds?

If a return on stocks of 6% to 9% over the coming decade doesn't seem overly generous, one must ask: *Compared to what?* Certainly bonds are the obvious and traditional alternative to stocks, and predicting bond returns is relatively simple. Why? Because the ten-year total return on an intermediate-term bond is determined primarily by the interest rate, i.e., the yield-to-maturity on the date of purchase. This relationship is highly predictable. Indeed the correlation between the initial yield on an intermediate-term U.S. Treasury bond and its subsequent ten-year return is a remarkable 0.91.<sup>2</sup> It turns out while reversion to the mean in P/E ratios is a powerful force in stock returns, it is not RTM but the current interest rate that drives subsequent bond returns.



Lord Keynes' concept of *enterprise*, "the yield on assets over their entire life," is therefore nicely represented by the yield on a diversified portfolio of U.S. Treasury and high-grade corporate bonds on the day we invest. And as the date of maturity approaches, the impact of speculative return resulting from interim changes in interest rates gradually dissolves. Using that methodology in the same *Journal of Portfolio Management* article in which I projected future stock returns, I also forecast bond returns for the coming decade. Since long-term returns on bonds are shaped predominately by *enterprise* (the current yield-to-maturity), the forecasting task is far less demanding than for stocks. My projection was for "a bond return of 9% (the bond yield at the outset), plus or minus 1.7 percentage points." The *actual* annual return on a combined Treasury-corporate bond portfolio was 7.7% for the 1990s, and 8.3% through May 2003. Not too shabby!

With the continuing decline of interest rates, the yield-to-maturity on a blended bond portfolio today is a far cry from that halcyon era. With intermediate Treasuries at 3.3%, and investment-grade corporates at 5½%, the combined yield is close to 4½%. Conclusion: Expected bond returns during the coming decade are in the 4½% range, only about one-half of the returns we enjoyed in the decade of the 1990s.

## Who Actually *Earns* the Market's Returns?

In sum, it seems difficult to escape the conclusion that we are looking ahead to a decade of lower returns in the financial markets, albeit a decade in which equities have the potential to provide a significant return premium over bonds. But please remember this: the returns I have projected are not of

<sup>2</sup> I should note that for an investor who chooses a zero-coupon ten-year bond, the correlation between initial yield and ten-year return would be exactly 1.00.

the real world. They are the *theoretical* returns delivered by the stock and bond markets, *before* the deduction of investment costs. That raises this crucial question: *Just who is it that earns the returns generated in our financial markets?*

Answer: Very few investors. *So whatever returns the financial markets are generous enough to deliver, please don't make the mistake of thinking you will actually earn those returns.* Of course all investors *as a group* must necessarily earn *precisely* the market return. But they do so only *before* the costs of investing are deducted. *After* these costs are taken into account—all of the advisory fees, the transaction costs, the consultants' costs, the operating costs, and the hidden costs of financial intermediation—the returns of investors must—and will—fall short of the market return by an amount precisely equal to the aggregate amount of those costs.

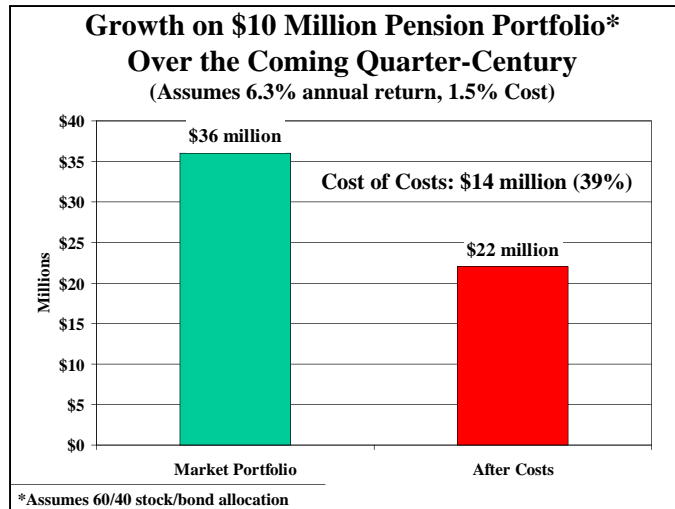
Beating the market *before* costs is a *zero-sum* game; beating the market *after* costs is a *loser's* game. *The great paradox of investing is that the very costs incurred by those managers who would help investors to beat the market, themselves constitute the reason that the managers as a group are destined to fail at the task.*

Do costs matter? You bet they do! And they matter most of all in diversified investment portfolios. Why? Because while much of the value of most consumer goods is measured by intangibles such as taste and tone and prestige and image, both the returns and the costs of an investment account are measured *entirely* by that most measurable of all assets, *dollars*. For investors, costs matter most when they are (1) easily calculable, (2) *directly* related to returns, and (3) compounded over time. So pension funds, endowment funds, and foundations—all institutions all with notably long-term—in a sense, perpetual—investment horizons can hardly fail to consider the role of costs. For just as the magic of compounding *returns* over, say, a quarter-century, carries investment values to almost unimaginable heights, so the tyranny of compounding *costs* results in an almost equally unimaginable deterioration in these returns.

### **The Powerful Impact of Costs**

Consider the impact of the costs entailed in the management of pension and endowment funds. On average, advisory fees, custody fees, and expenses, probably come to about 0.7% per year of investment assets. When we add in portfolio transaction costs and opportunity cost (institutional accounts often maintain a modest cash position), the total cost for an average-sized institution are probably about 1.5% per year. (For larger institutions, 1% might be a more reliable figure. For mutual funds, all-in costs average a stunning 2½% to 3%.)

It must be obvious that in an era of lower returns, costs will play a particularly confiscatory role. If future stock returns are kind enough to average 7½% and future bond returns come in at 4½%, a 60/40 portfolio would produce a 6.3% annual return before costs, and the appreciation on an initial \$10,000,000 portfolio over the subsequent 25 years would come to \$36,000,000. In an era of subdued returns, not too shabby! But *after* costs of 1.5%, the return would be just 4.8% and the appreciation just \$22,000,000—a shortfall of \$14 million, nearly 40% less. (For an endowment or foundation making annual distributions of 5% of principal, of course, the *nominal* value of the portfolio would actually decline, and the *real* value likely seemingly impaired.)



So my message is simple: As you do your financial planning, (1) plan for an era of lower returns in the financial markets; (2) focus on minimizing the frictional costs of investing—*all* of them, but especially investment counsel fees and portfolio turnover costs. And (3) heed the logic of passive, index-oriented investing—not only in stocks but in bonds as well. Don’t take my word for it: Listen to Warren Buffett’s wise (and outspoken!) partner Charles Munger, who several years ago told a conference of endowment fund managers:

“For the obvious reasons . . . I think indexing is a wiser choice for the average foundation than what it is now doing in equity investment . . . particularly so if its present total croupier costs exceed 1% of principal per annum.”

### The Mystery of America’s Corporate Pension Funds

To an important extent, however, all three of those messages seem to have been lost on America’s corporations. As corporations project the future returns they expect to earn on their pension funds, they do exactly what Keynes warned them *not* to do. In essence, they actually apply to the future inductive arguments based on past experience, and ignore the broad reasons *why* past experience is what it was.

These may seem like harsh words, but how else would one explain that the typical assumed annual return on U.S. pension funds rose from 7% in 1980 to nearly 10% in 2001? Indeed, corporations actually seem proud of extrapolating the past into the future. Consider these typical words, *verbatim* from the 2001 annual report of one of America’s largest manufacturing corporations, and forecasting a 10% future return on its pension plan: “Our asset return assumption is derived from a detailed study conducted by our actuaries and our asset management group, and *is based on long-term historical returns.*” This methodology could hardly be plainer. Or more wrong.

Rather than accepting this firm’s assumed future return on its pension plan, let’s see what returns might be generated using the realistic expectations—and realistic costs—described earlier. Assume that 60% of the portfolio is in stocks earning 7½% (contributing 4.5 percentage points to returns), and 40% in bonds earning 4½% (another 1.8 percentage points), for a total return of 6.3% before costs. Subtract 1.5 percentage points of cost and the result is an annual net return of 4.8%, less than *one-half (!)* of the firm’s 10% prediction!

Realistic Return Assumptions – Corporate Pension Plan						
	1.	2.	3. (1 x 2)	4.	5.	6. (4 – 5)
Class	Allocation	Projected Return	Return Impact	Gross Return	Expenses	Net Return
Equities	60%	7.5%	4.5%	} 6.3%	1.5%	4.8%
Bonds	40	4.5	1.8			

Oddly enough, the chief executive of this corporation and I “met” on a television show early this year and discussed our contrasting views. He argued that the pension fund would engage successful equity managers and was aggressively using alternative asset classes, largely hedge funds. He produced no analysis (this was *television*, after all!), but perhaps he got my message. For when the firm’s annual report for 2002 was issued a few months later, it announced that the assumed return for 2003 would be dropped to 9%. What is more, the language had changed: “While the study gives appropriate consideration to recent fund performance and historical returns, the assumption is primarily a long-term prospective rate.” So let’s consider applying the methodology I’ve presented and see what it might take to deliver that 9% return on the company’s \$61 billion of pension assets.

We don’t know what investments compose this firm’s new “policy portfolio.” So let’s make some reasonable assumptions about allocations: 30% in equities, 30% in bonds, 20% in venture capital, and 20% in hedge funds. Then let’s assume that its equity managers beat the market by 3½% a year and that its bond managers win by ¼%. Project venture capital at 12%, with smart managers who earn 18%, and hedge fund managers who earn 17% per year. Then deduct costs, which happen to average 2.7%. Voila! A net return for the pension fund of 9% per year!

Leave aside for the moment that equity managers who can beat the market by 3½% a year are conspicuous by their absence. Leave aside, too, the risks they’ll have to take to do so. Then note that the assumed venture capital returns and hedge fund returns are far above even the historical norms inflated by the speculative boom in IPOs during the market madness of the late 1990s. Then ignore the obviously staggering odds against finding a *group* of managers who could exceed those norms by six or seven percentage points per year. Surely most investment professionals would consider these Herculean assumptions absurd. But who really knows?



Getting to a 9% Return: A Template for Corporate Annual Reports						
	1.	2.	3.	4.	5. (2+3-4)	6. (1 x 5)
Class	Allocation	Projected Return	Value Added	Expenses	Net Return	Return Impact
Equities	30%	7.5%	3.5%	2.0%	9.0%	2.7%
Bonds	30	4.5	0.25	1.0	3.75	1.1
Venture Cap.	20	12.0	6.0	3.0	15.0	3.0
Hedge Funds	20	10.0	7.0	6.0	11.0	2.2
Total Return:						9.0%

But my point is not that no one can be sure. Rather it is that each corporation’s annual financial statements should present to shareholders a simple table such as this one so that its owners can make a fair determination of the reasonableness of the pension plan’s earning assumptions. After all, to do otherwise is, using Keynes’ well-chosen word, “dangerous.” I’d put such a report high on my list of financial statement priorities. *It is an idea whose time has come.*

### “Policy Portfolios Are Obsolete”

The sum and substance of what I’m recommending must be both conventional and obvious. For most pension funds, endowments, and foundations: (1) Maintain an appropriate policy portfolio (probably in the range of 40% to 60% in stocks, with the remainder in investment-grade bonds). (2) Diversify to the maximum possible extent. (3) Hold investment costs to the bare-bones minimum. (4) Be realistic with your return expectations, and content with the lower financial market returns that seem in prospect. (5) Hold on to your hats!

In putting forth this advice, I’m well aware—as perhaps some of you are too—that it is directly contrary to the well-publicized advice recently given by one of the financial field’s leading intellectual lights: *Policy portfolios are obsolete.* So said Peter L. Bernstein, respected investment strategist, economist, best-selling author, and the recipient of a remarkable string of professional awards, in the March 2003 edition of his “Economics and Portfolio Strategy” (soon to celebrate its 30<sup>th</sup> anniversary).

It’s not easy to sum up Mr. Bernstein’s reasoning and recommendations, but let me try to do so even-handedly: *Forget the policy portfolio. We simply do not know about the future. There is no assurance that historical experience will replay itself in any shape, form, or sequence. The expected equity premium is not only low, but doesn’t take into account the abnormalities lurking in today’s investment environment. We’re living in unprecedented times.*

So what’s to be done? Again, here’s his position: *Get rid of the extra freight of long-term optimization and let short-term forces play the dominant role. Rely on a “bipolar” portfolio, with one segment for good news and one for bad news, reaching for the most volatile asset classes to do the job. Build ramparts around equities, such as gold futures, venture capital, real estate, instruments denominated in foreign currencies, TIPS, and long-term bonds.*

And the icing on the cake: *Don't do any of these things permanently. Opportunities and risks will come and go in short order. Change allocations frequently. Be flexible. "Buy and hold" is the past; "market timing" is the future.*

### Who's Right?

Despite Mr. Bernstein's extraordinary credentials, I fear that his advice is wide of the mark, even ill-begotten. First of all, as a group we *can't* abandon the policy portfolio, for *it actually exists*. Specifically, the U.S. policy portfolio (all publicly-held securities) is currently valued at \$20 trillion, \$10.6 trillion (53%) in equities, \$9.4 trillion (46%) in bonds. In essence, the reality is that for each investor who decides to *reduce* equities by, say, 25 percentage points, there will be another investor who inevitably must *increase* equities by the very same 25 percentage points. One investor will be right, the other wrong, although, because of transaction costs, *together* they will lose ground to the return of the policy portfolio.

<b>The U.S. Policy Portfolio</b>		
	<b>Value</b> <u>(trillions)</u>	<b>Share</b>
<b>Equities</b>	<b>\$10.6</b>	<b>53%</b>
<b>Bonds</b>		
<b>US Tr. &amp; Agen.</b>	<b>2.8</b>	<b>14</b>
<b>Mort.-Backed</b>	<b>2.8</b>	<b>14</b>
<b>Corporate</b>	<b>2.6</b>	<b>13</b>
<b>Municipals</b>	<b>0.9</b>	<b>5</b>
<b>Other</b>	<b>0.3</b>	<b>1</b>
	<u><b>\$9.4</b></u>	<u><b>47</b></u>
<b>Total</b>	<b>\$20.0</b>	<b>100%</b>

Of course, Mr. Bernstein is right that we live in unprecedented times and that we simply do not know about the future. But aren't *all* times by definition unprecedented? And do we *ever* know what the future holds? For me, the soundest way to develop rational expectations for the years ahead remains the disaggregation of future investment returns into dividend yield, earnings growth, and P/E impact. Once that is done, I know of no better way to guard against uncertainty than with a policy portfolio that balances stocks—with their obvious risks and equally obvious potential for growth—and bonds—with their obvious characteristics of higher income and relative stability—in a manner appropriate to each institution's financial goals and risk tolerance. More than incidentally, the bond portfolio can reflect the institution's need for yield and its willingness to accept price risk (through its choice of quality and maturities), as well as its inflation expectations (through TIPs).

My (perhaps) knee-jerk reaction against letting short-term forces dominate investment strategy is that the "good news" and "bad news" we observe each day is largely noise, indeed, using Shakespeare's words, "a tale told by an idiot, full of sound and fury, signifying nothing." If I have learned *anything* in my 52 years in this marvelous field, it is that, for a given individual or institution, the emotions of investing have destroyed far more potential investment returns than the economics of investing have ever *dreamed* of destroying.

Of course, it's especially tempting to reach for higher returns when the outlook for returns on liquid, publicly-held stocks and bonds is as subdued as I have suggested today. But how different is that reaction from the reaction of a gambler at the roulette table, who, when he sees his pile of chips diminish, realizes he'll never recoup by betting on the odd or even numbers, or on red and black, and decides to place his entire remaining hoard on, say, number eight? Of course he may win—and win *big*—but the odds happen to be 38 to one against him. At some point, serious long-term investors have to sit back and simply accept whatever returns the financial markets are generous enough to provide and plan accordingly. *For the further out on the long limb of risk we climb, the greater the possibility it will break.*

In this context, I can do no better than reiterating the position Peter Bernstein held just a year earlier, in his essay “The 60/40 Solution.”

*Few decisions in life motivated by greed ever have happy outcomes. Unless you are that rarest of birds, someone who is cool under the rapid-fire, high-pressure decision making required to maximize your returns, let others take such risks, and allow your portfolio to plug along at a slower speed. In investing, tortoises tend to win far more often than hares over the turns of the market cycle. . . . Placing large bets on an unknown future is worse than gambling, because at least in gambling you know the odds. This is why I propose restoring 60/40 [stocks/bonds] to its rightful place as the center of gravity of asset allocation for long-term investors.*

### Considering Alternative Assets

Looking for “something better” than stocks and bonds implies that there *is* something better. Is there? Today, the “big new idea” for gaining extra returns is “alternative investments,” although they are just stocks and bonds of a different character and mix. I wonder if their popularity isn't simply the inevitable reaction of investors (and brokers) to one of history's great bear markets who want to buy (or sell!) something new. If “it's always darkest before the dawn,” abandoning stocks because of the siren song of alternatives may be the wrong strategy at the wrong time.

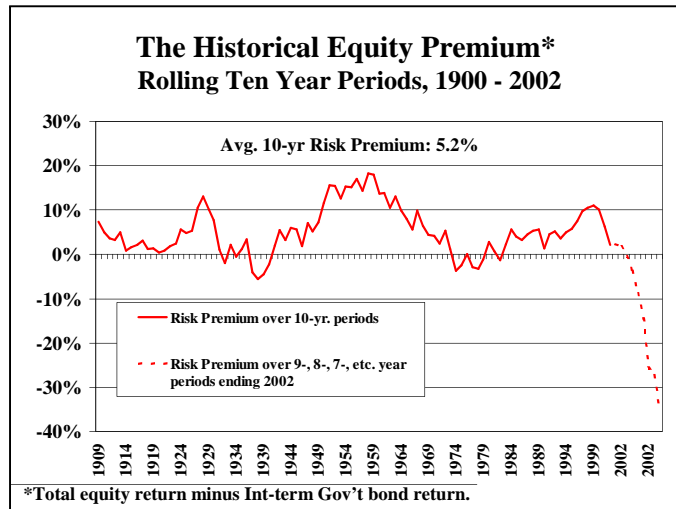
And so as you consider alternative investments, please don't forget this paradox: Even as their reduced covariance with equities is said to *reduce* the risk in a *portfolio* (i.e., reduce its standard deviation), individually they carry *increased* risk. Many individual hedge funds, for example, are taking risks, often hidden, that would send chills up one's spine. (Think of Long-Term Capital Management; think of the 700 hedge funds that reportedly folded last year.) International investments are riskier, too. (How could stocks in, say France or Indonesia or Turkey possibly be deemed *less* risky than those in the U.S.?) Sure, gold is a wonderful diversifier, but like any pure commodity that generates *no* economic return, and whose entire return is based on price speculation, it carries *enormous* risk. And, no, please don't accept the canard that *any* investment class can at once defy common sense and history and offer “absolute return.” *Do what you will, capital is at hazard*

What is more, as money flows into these alternative asset classes, the invisible hand of competition in the financial markets often creates perverse and counterproductive consequences. When more investment dollars chase a limited supply of goods in venture capital and in opportunistic hedging, the value—if any—in these strategies is apt to get arbitrated away, even as yesterday's successful managers are flooded with money that precludes their repeating prior achievements. However successfully these alternative asset strategies have been implemented in the past at Princeton, Yale, and Harvard (at last, the forgotten “Big Three” of football's yesteryear return in triumph on another field of play!), we would be well reminded that “nothing fails like success.” Let's not forget Immanuel Kant's categorical imperative: “Act only on that maxim which can at the same time become a universal law.”

Since, for investors as a group, the return on the policy portfolio, as it exists at any moment, is absolute, there is *no* investment strategy that meets that universal imperative.

### Whither the Equity Premium?

Now when Peter Bernstein and Robert L. Arnott tell us that the future equity premium will, if it exists at all, be miniscule, only a fool ignores their comprehensive and provocative analysis.<sup>3</sup> *And of course they may be right.* Indeed my own expectation of a 4.2% equity premium (stocks providing a return of roughly 7½%, yield on 10-year Treasury’s 3.3%) is below the average ten-year norm of 5.2%. But risk premia are anything but stationary, running as high as 15% in the decades when interest rates were artificially low from the early 1950s through the early 1960s, and 10% or so in the decades leading up to the 1929 and 2000 peaks. What is more, positive premia are hardly guaranteed, with one moving decade of every eight actually having been negative, largely during the 1930s and 1970s. There’s no arguing with the Bernstein-Arnott methodology, but the outcome depends on what numbers we put on the blank slate of the future. While other respected analysts are using numbers more akin to mine (often by taking into account stock buybacks as dividend equivalents in returning capital to investors), the reality is that the actual risk premium that stocks will deliver over the coming decade is, truth told, a mystery. As Keynes warned us in another context, “we simply do not know.” Less gracefully, I would warn, “you pays your money and you takes your choice.”



But in an uncertain world, nothing looks better to me than “*the nth degree*” of diversification. Company failures may rise; the co-opting of accountants by their clients reduces the earnings reliability of individual firms; and market participants have passively accepted P/E ratios based on past (or even forward-looking) *operating* “earnings” of firms that have made suspect capital commitments and engaged in mergers that destroyed corporate values and ignore *reported* earnings, the ultimate reality check. Together, these factors suggest that the financial statements of some companies have lost touch with reality. Which ones? It’s hard to know in advance. The ultimate equity strategy, therefore, is to eliminate specific stock risk and own *American business*. Doing that at minimal cost, of course, leads to a low-cost indexing strategy.

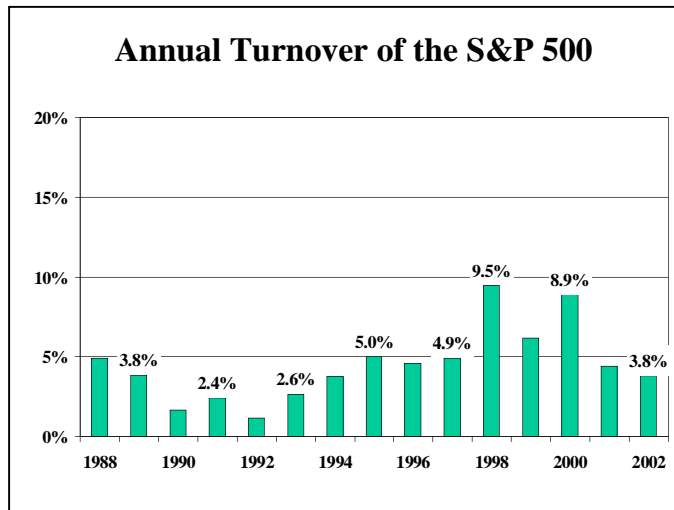
<sup>3</sup> “What Risk Premium is Normal.” *Financial Analysts Journal*, March/April 2002. The authors conclude that, “the long-term forward-looking risk premium is nowhere near the 5 percent level of the past; today it may well be near zero, perhaps even negative.”

## Indexing: A Point of Inflection?

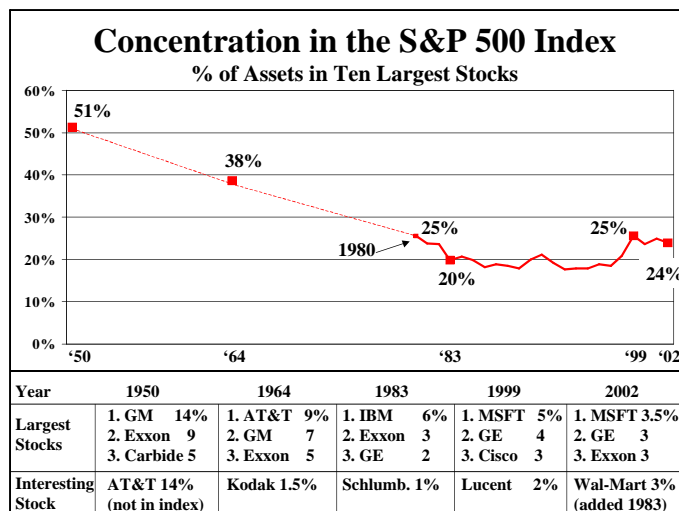
Mr. Bernstein's thesis, however, seems to suggest just the opposite. He writes that since index turnover is rising and diversification is narrowing, "indexing has passed through a point of inflection." But I see *no evidence whatsoever* of the "elevated turnover" or "bizarre concentration" that troubles him.

The fact is that the S&P 500 Index has proved to be a consistent and reliable measure of the returns of the total U.S. stock market ever since data collection began in 1928. And the record clearly shows, while such an all-market strategy cannot be *the* winning strategy, it must always be *a* winning strategy. Why? *Solely* because of its complete diversification and its minimal management expenses and turnover costs, the return on the all-market index portfolio is *guaranteed* to be superior to that of other investors as a group. Statistics tell us that in a single year, the passive market portfolio is apt to outpace about 60% of all moderate-cost actively managed portfolios. But over 15 years it will outpace some 80% of such active portfolios, over 30 years about 90%, and over 50 years, about 95%.

With the market's return available for the taking, one has to wonder what is the value of departing from it. Yes, funny things happen to the S&P 500 Index as substitutions occur, although the best index fund managers have tracked the return of the S&P500 with remarkable precision. Further, turnover seems to be in a downturn—just 3.8% last year, the lowest since 1994, identical to 1989 and about two-thirds *below* the record 9% levels reached in 1998 and 2000. When one compares that 3.8% annual turnover with the 110% turnover in the average actively managed mutual fund last year, we're looking at something akin to the difference between light and darkness. (You can probably guess in which category I'd place indexing!)



It's easy to argue, of course that having, as the S&P 500 Index currently does, 24% of assets in its 10 largest stocks is inadequate diversification. But the reality is that that level of concentration is in fact also *below* historic norms. In 1950, for example, the largest ten stocks composed fully 51%(!) of the total value of the Index, and even in 1964 the top ten composed 38%. Is such diversification adequate? There's no way to be certain. But if the actual goal of investing is to capture as close as possible to 100% of the return of the stock market, one simply tries to own the market itself, warts and all, with each company weighted by its own market capitalization.



## Market Timing

These issues, of course, are all worthy of discussion and debate, and I salute Peter Bernstein for marching, red cape and all, into an arena filled with bulls—and bears. But on the issue of market timing, my views could hardly be more divergent from his. Leave aside the fact that, as noted earlier, for investors as a group, *there is no market timing*. For better or worse, all of us investors together own the policy portfolio. And when, as it were, one investor borrows from Peter (no pun intended!) to pay Paul, another does the reverse, and the policy portfolio neither knows nor cares.

Individually, of course, any one of us has the opportunity to win by departing from the policy portfolio. But on what rationale will we base our market timing? In our conviction about the prospective equity premium? Concern about the *known* risks that are already presumptively reflected in the level of market prices? Concern about the *unknown* risks? (It is no mean task to divine the unknowable.) Yes, as Peter Bernstein says, “opportunities and risks will (likely!) appear and disappear in short order.” But count me as one who simply doesn’t believe that market timing works. Don’t forget that *your* incredible success in consistently making each move at the *right* time in the market is but *my* pathetic failure in making each move at the *wrong* time. One of us, metaphorically speaking, must be on the opposite side of each and every trade. A lifetime of experience in this business makes me profoundly skeptical of market timing. I don’t know anyone who can do it successfully, nor any one who has done so in the past. Heck, I don’t even know anyone who *knows* anyone who has timed the market with consistent, successful, replicable results.

It is quite difficult enough to make even one timing decision correctly. But you have to be right twice, for the act of, say, getting *out* of the market implies the act of getting *in* later, and at a more favorable level. But when, pray? You’ll have to tell me. And if the odds of making the right decision are, because of costs, even less than 50/50, the odds of making two right decisions are even less than one out of four. And the odds of making, say a dozen correct decisions over, say three years, hardly excessive for a strategy that is *based* on market timing, seems doomed to failure—one out of 4,096, even when we exclude the negative impact of the portfolio transaction costs entailed in the implementation of all those decisions.

What is more, my basic belief that sticking with your own policy portfolio is the right course of action is that the economics of investing are, in the long run, *productive*, and the emotions of investing *counterproductive*. The task of the successful investor is to let the economics do the talking, and relegate his emotions to a sound-proof closet. Thus, perhaps the best advice I can offer today to the institution

whose policy portfolio is suitable for its own needs, and whose principal elements include broad diversification and low-cost, is: *Don't do something. Just stand there!*

## Wrapping Up

It's never given to us to know about the returns that stocks and bonds will deliver in the years ahead, nor about the future returns that will be achieved by alternatives to the policy portfolio. But I urge you not to forget that, for all the inevitable density in the fog of investing, there remains much that we *do* know:

- We *know* the sources of returns in the stock and bond markets, and that's the beginning of wisdom.
- We *know* that cost matters, moderately in the short run and overpoweringly in the long run.
- We *know* that *specific-security* risk can be eliminated by diversification, so that only *market* risk remains. (And that risk seems quite large enough, thank you!)
- We *know* that neither beating the market nor successful market timing can be generalized without self-contradiction.
- We *know* that alternative asset classes aren't really "alternative," but simply pools of capital that invest—or over-invest or disinvest—in the very stocks and bonds that comprise the policy portfolio.
- Finally, we *know* what we *don't* know. We can never be certain how our world will look *tomorrow*, and we know even less about how it will look a decade hence. But we also know that *not* investing is doomed to failure.

Yet our task remains: Earning for our clients and beneficiaries their fair share of whatever returns that our financial markets are generous enough to provide.

There's no need for absolutes, for this is not an "all or nothing" business. There's no reason, for example, that *one* portion of your investment account can't be dedicated to the policy portfolio—I'd call that "serious money"—and a separate portion dedicated to those other volatile specialty alternative investments—"opportunistic money" if you like them; "funny money" if you're skeptical. (It won't surprise you that I'd set the "serious money" portion at from 85% to 100% of the total portfolio.) But there comes a time when talk ends, and the time arrives to act—or *not* act—on a new direction. That decision is in your hands. *Look before you leap!*

The opinions expressed in this speech do not necessarily represent the views of Vanguard's present management.

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