Happiness or Misery?
Investment Performance in an Age of "Investment Relativism"

Remarks by
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Today, more than any time in the history of the financial markets, the quest for investment success is focused on relative performance over the short-term. We have entered what I call "The Age of Investment Relativism," as all eyes seem focused on a comparison that has become as much a part of our lives as the daily fluctuations in the stock market: How did the equity portfolio we manage perform relative to the Standard & Poor's 500 Composite Stock Price Index? Whether we experience happiness or misery seems to depend on how we answer that question.

The impecunious and mercurial Mr. Micawber (in Charles Dickens' *David Copperfield*) set the stage for my theme some 150 years ago, bestowing happiness and misery according to the following formula: "Annual income, twenty pounds, annual expenditures nineteen six, result happiness. Annual income, twenty pounds, annual expenditures twenty pounds six, result misery."

Similarly, as investment managers today, we work in a system that seems to operate according to this updated formula: "market return, eighteen point six; my return nineteen point one; result happiness. Market return, eighteen point six, my return fifteen point seven; result misery."

That latter comparison, in fact, expresses the shortfall of the average domestic equity mutual fund to the stock market (as measured by the S&P 500 Index) over the past 15 years—18.6% vs. 15.7%. Surely it suggests why most managers of equity funds are feeling considerable professional misery—if hardly financial misery—today.

The more things change, it seems, the more they remain the same.

If the issue were simply "did the adviser outpace the market?" over the decade, the answer is clear. Most advisers did *not*. Indeed, as a matter of simple mathematics and elementary logic, most advisers *cannot* outpace the market. And it is only fair that advisers should fully disclose not only the absolute rates of return they have achieved—in interim periods and over the long term—but how those returns have compared to the returns that would have been achieved by an *appropriate* benchmark standard accepted by manager and client alike as a prime measure of success over the long pull.

But we have long since passed that basic point of departure. Now we see a powerful focus on quarterly relative performance. And the performance is invariably related to a single, omnipresent "bogey" (a Scottish word meaning "goblin," and few advisers regard it in kinder terms), the redoubtable S&P 500 Stock Index.[1] What is more, we often see weekly comparisons, and even daily comparisons—after a significant market *drop* but, curiously, rarely after a sharp rally. "Having gone up less for all those years," the client asks his fund manager, "did you go down less when the market dropped 554 points a few Mondays ago?" The oddly and narrowly constructed Dow Jones Industrial Average, of course, remains our basic measure of daily market swings, though the market-value-weighted S&P 500 is equally invariably used when the time comes to make relative return comparisons over longer periods.

Today, just as institutional pension officers scowl over their bifocals as they review the quarterly performance comparisons in regular meetings with their investment advisers, so individual investors receive the data each quarter, either in real time on their computers, or as late (shocking!) as the next morning's newspaper. It seems dubious in the extreme that such short-term focus can be other than counterproductive.

I should point out that these rat-a-tat volleys of comparative information are of relatively recent vintage. Indeed, mutual fund sponsors were prohibited by the Statement of Policy of the NASD from publishing "total returns"—even *without* making comparisons—from 1950 through

[1] In fact, I must confess to being amused by the irony that the "bogle" is in fact the earliest-known goblin, already part of Scottish literature in 1500. (Some years ago, I was called "Beta Bogle, the data devil.") Given my role in forming the first index mutual fund in 1975, it is not without possibility that active managers place me in the goblin category.

1965. But, by the early 1970s, the total-return teetotaler of the old days had become a social drinker. It may not be stretching things to say that by the early 1990s he was on the verge of becoming an alcoholic—comparisonwise, to be sure.

It doesn't really matter whether today's omnipresent S&P comparison has been fomented by the information overload in this miraculous age of communications technology. Or by the self-styled sophistication of the institutional client, who seems to have a vested interest in frequently changing advisers. Or by the appetite of the burgeoning mutual fund industry—with its daily asset valuations—as funds have become the investment of choice among American families. Or by the overly aggressive marketing of funds. (Have *any* of the funds you see advertised *ever* fallen short of the S&P 500?) Relative investment performance—"investment relativism" if you will—is the order of the day.

The problem with all of this is not that managers should not be held to a performance standard—of course they should—but that they are held to a single standard irrespective of client objectives, and that the measurements take place during extremely short periods. We might well ask: "To what avail?"

Enter "Closet Indexing"

Surely it is no service to our clients that many fund managers, caught up in the perception that beating the market each quarter is happiness and losing is misery, seem to use the 500 Index as the mandatory measuring stick for their own portfolios—i.e., "S&P technology stocks, 14% of the value of the index, 21% of my portfolio; GE, 3.0% of the S&P, 1.2% of my portfolio," and so on. All with this implicit question: "Is my 'bet' (as it is usually described) the right one? Or should I align my portfolio more closely to the index?" There's a lot of casino capitalism by managers and clients alike going on in investing today, and I suppose "betting"—even betting *not* to lose—is as good as any word to characterize this over-reliance on the composition of an unmanaged and relatively unchanging market index.

In recent years, it seems to me, this strategy has become almost tacitly accepted. Indeed, there is considerable anecdotal evidence that we have gone beyond mere measurement to action, as in "I think Coca-Cola is grotesquely overvalued. But, in case it keeps going up, I'm going to buy a 1.5% portfolio position for protection. Since that's less than Coca-Cola's 2.0% weight in the S&P 500 Index, I'll have a good defensive position versus the Index when it takes the tumble it so richly deserves." Whatever the case, isn't that philosophy the antithesis of professional investment management? Hasn't it become the formula followed by a nervous portfolio manager anxious to hold his or her job? Isn't it the result of the marketing department's holding sway over the investment department? In each case my finding would be: "Guilty as charged."

Such a "closet indexing" strategy is, in my view, more pervasive than most investors recognize (or have been led to recognize). But, whether it takes place at the margin of a portfolio or permeates it, I've never seen it disclosed in a fund's prospectus. (A cynic might wonder whether fund independent directors and trustees have been fully informed on the subject.) To be sure, so far it largely applies, when it does, to the large-cap managers. Closet indexing is a relatively simple process when the ten largest stocks in the S&P 500 Index represent nearly 20% of the Index, the largest 50 stocks, 50%. Even if it creeps into the small cap side of the business, it seems unlikely to permeate it, since the largest ten stocks comprise just 1.7% of the Russell 2500 Small Cap Index, the largest 50 stocks just 8.2%. That said, the fact is that large-cap strategies dominate the financial markets. Large-cap stocks account for roughly two-thirds of the assets of all equity mutual funds, and an even higher proportion of institutional assets.

And closet indexing may well be having an impact on stock returns. While I'd never ascribe causality to any of the myriad factors that affect the price of a stock, it seems more than coincidence that so far in 1997 the largest gains among the blue chip stocks whose capitalizations dominate the market have come to those stocks in which mutual funds have the *smallest* relative positions. Yet the five largest stocks in the 500 Index most *under*owned by mutual funds are up almost 50% so far this year, compared to an average gain of roughly 30% for the remaining 495 stocks.

Put another way, could it be that active managers, in their passion to compete with the passive Index, are primarily responsible for driving up the price of the underowned large stocks in the Index, giving it, over the past three years, the most formidable record of outpacing active fund managers in the history of the Index, surpassing 90% of equity funds? Are managers forcing their portfolios to become more Index-like, so as to avoid serious shortfalls in the quarterly comparison "sweepstakes" (another word from the world of gambling)? And, if so, are managers sowing the seeds of their own performance inferiority today? Stranger things have happened.

Well, these trends suggest why I describe the present era as the Age of Investment Relativism, in which the overarching goal is to avoid inferior short-term returns relative to the S&P 500, rather than to achieve superior absolute long-term returns. Since quantitative science entered the business of mutual fund performance in the mid-1980s, relativism has become the basis of a comprehensive performance measurement system. *Beta* (risk, measured by the fund's price volatility relative to the 500 Index), and *Alpha* (the fund's rate of relative return adjusted for risk) have entered our lexicon. We also have the Sharpe Ratio, measuring a fund's excess return over the Treasury bill relative to its risk (standard deviation), not to be confused with the information ratio (Selection Sharpe Ratio), which measures excess return over a benchmark standard—usually, of course, our devilish friend, the S&P 500. I do not believe that this focus on simplistic mathematical precision is an entirely healthy state of being for managers or for their clients, nor for the market itself. Yet there is, as yet, no end in sight—no *Omega* on the horizon.

The Real Villain: The Index Fund

Surely the most important reason by far for the defensive reaction of managers to index comparisons is the index fund itself. The *index* is a mean adversary, but the index *fund* is the real villain of the piece. Once upon a time, managers could (and did) use the argument, "yeah, but who can buy the market?" And later, "yeah, but the index is theoretical, and it would cost a lot to buy, be expensive to operate, and you wouldn't be able to nearly match the index." The low-cost index fund has given the lie to these foolish make-weight arguments. But even though Vanguard founded the first index mutual fund began in 1975, fully 22 years ago (perhaps the bogle goblin really *was* the data devil), it was not until the mid-1990s that index funds began to catch the fancy of investors and become a formidable competitor for their assets.

And tough competition they are. As recently as 1994, index funds accounted for only 3% of equity fund flow ($4 billion). In 1997, index fund inflow should reach a 15% share ($30 billion). What is more, tough in the *marketplace* they should be. For they have been tough in the *market*. As I noted at the outset, the total return on the original S&P 500 index fund (net of costs) over the past 15 years was 18.2% annually, compared to 15.7% for the average U.S. equity fund. While this period was an especially fine one for the large cap stocks in the S&P, even a *total* stock market index fund—the Wilshire 5000 Equity Index, adjusted to account for estimated costs—would have returned 17.7%, only 0.5 percentage points shy of the 500 and still an advantage of two full percentage points in annual return. (And that's even before fund sales charges are taken into account!)

The fact is that, at least in my judgment, the index fund *should be* the investment of choice. It is the odds-on (pardon another expression from the world of gambling) favorite to win the race (another!) against three of every four managers. We know that, for the market as a totality, low-cost investing—which is really all that an index fund is about—ineluctably beats high-cost investing over the long run. And while I happen to prefer the all-market index because of its complete diversification and nominal portfolio turnover, I can't imagine that the long-term return of the S&P 500 Index, comprising as it does 70% of the market, will vary significantly from the return of the total market. In any event, the marketplace, now dominated by S&P 500 indexing, is increasingly moving in the direction of all-market indexing. I fully expect that over the next few years this broader strategy will become the principal choice for institutional indexers and fund indexers alike.

I also strongly favor the use of indexes from market segments as the standards for funds with particular investment styles (i.e., large-cap value, small-cap growth, etc.). However managers should be warned that, taking into account relative return (generally solid for the segment indexes across the board) as well as relative risk (generally *significantly* lower for the indexes, a point almost universally ignored), the advantages of an index strategy are equally apparent at all market cap levels and in all investment styles and venues. So, market segment index funds seem certain to take their proper place in the marketplace, and all forms of indexing—now about 15% of institutionally-managed equity assets, will continue to grow, perhaps to as much as 25% to 30% a decade hence.

The Rise of Quantitative Investing

And the bad news for traditional managers continues. Another form of index-like competition is emerging, and I'm confident it too will take its place in the field. I refer to what are called "quantitative" investment strategies, which I define to be computer-driven strategies that rely rigidly and exclusively on mathematical formulas to manage investment portfolios. I differentiate the use of quantitative techniques as the foundation of portfolio strategy and selection from the clearly pervasive use of computers to screen and value individual stocks and stock groups as part of the traditional security-analyst-based management process. ("We're *all* quants now.") Today, industry estimates place the assets managed by quants at $100 billion, and the growth rate is strong.

Some of these quantitative strategies might fairly be described as the ultimate form of investment relativism. But they must not be confused with closet indexing. With fully disclosed policies and strategies, they are hardly hidden in the closet; their strategies are rigorous and controlled, not random and intuitive; and their costs are often well below conventional norms. (It's far less costly to run a computer program than to employ a large portfolio research and management staff.)

Typically known as enhanced index funds, these funds seek to outpace a market index. The first mutual fund in this category began in 1986, and has slightly bettered the index itself, by enough to give it a significant edge over an index fund. The overall evidence of success in such "disciplined" and/or "sector neutral" strategies, as they are known, is quite mixed, but my guess is that they'll prove attractive to investors who realize the value of indexing, but can't quite abandon all hope that they can identify in advance active managers who will outperform.

Other strategies—sometimes known as "Positive Alpha" or "market neutral"—are based on achieving, not a rate of relative return, but an absolute rate of return. These strategies may gain an advantage by their ability to use specialized investment techniques (including short-selling, hedging, etc.) and often rely on strict quantitative discipline. These managers may gain an advantage by capitalizing on the fund industry's Achilles' heel: asset size. When assets under management are limited, the drag of transaction costs is held within tolerable levels that do not themselves frustrate the implementation of aggressive investment policies. Both of these developing quantitative approaches—Enhanced Indexing and Positive Alpha—represent important challenges to the *status quo*.

The Changing Role of the Traditional Active Manager

Faced with this competition, how should the traditional manager respond? If closet indexing is the wrong response, indeed a counterproductive one—as I believe it is—what is the right one? First, a given: today and for as far ahead as the eye can see, each adviser should freely acknowledge that he or she should be expected to outpace an agreed-upon market performance standard over the long run, and strive to do just that. What else is an adviser *supposed* to do? How else can we measure whether any economic value being created is sufficient to justify the cost of retaining the adviser in the first place? Of course, the standard need not necessarily be the S&P 500 Index (though it would be appropriate for large cap funds with a blended—growth stocks *and* value stocks—style). Broader all-market indexes will also become part of the world of investing.

And other styles may also be considered as standards. Indexes measuring returns for style/market cap "boxes" (nine, under the *Morningstar* system) will also become part of our world. It is simply unrealistic for small-cap managers, or mid-cap managers (or for that matter high-cost large-cap managers, though they have the best chance) to *duplicate* the long-term record of an all-market index. They should be measured against the market segment (or segments) in which they choose to participate. Weighted indexes combining appropriate levels of large cap and small cap, value and growth, and international surely make sense. That said, however, blame the *client* if he selects a small-cap strategy and the adviser outperforms the small-cap universe yet fails to outpace the total market over the long term. But blame the *adviser* if he overweights small-cap in the hope of beating the total market over the long term but fails to do so.

Further, consider the role of bonds and cash reserves in the asset mix of the target index. Stock indexes (and index funds), to state the obvious, hold neither. A balanced fund should be measured against a balanced mix of stocks, bonds, and reserves. And it would not necessarily be foolish for an adviser to an equity fund which holds a fairly consistent 5% to 15% position in cash reserves to use a similarly adjusted stock/reserve benchmark. Such a policy would dampen the fund's volatility during those inevitable times when stock prices tumble. But "slightly lower" must be what the client is given to expect. In any event, it is important that the client understand that it is next to impossible to "market-time" a changing cash position. And most important of all, the client must understand that, in a positive stock market over time, he will pay a commensurate price in relative rate of return. Put simply, he should understand that, over the long-run, *a percentage point increase in volatility is meaningless; a percentage point increase in return is priceless*. That powerful, and, I think virtually unarguable syllogism, should give both adviser and client ample food for thought.

Confronting the Index Challenge

In this age of investment relativism, I'm convinced that—faced with the competition of index investing and quantitative investing—too many managers today are responding in the most ineffective manner possible, by "closet indexing." *But shaping an inchoate and undisclosed policy around the structure of an index is, finally, managerial suicide.* It is the ultimate concession to the unarguable economic value of the low-cost, passively managed index fund over the high-cost, actively managed traditional fund. The managed fund then provides an ever more index-like portfolio, until it becomes a virtual index fund—but without the added value provided by low operating and advisory expenses, microscopic portfolio turnover and commensurately lower taxes, and a fully invested participation in equities. In short, today's *chance* of victory, as small as it demonstrably is, will become tomorrow's *certainty* of defeat if managers offer tacit index funds with high fees, high portfolio turnover, and a significant position in cash reserves. And it is the mutual fund shareholder who will pay the price.

Relativism suggests that managers are becoming more *similar* to the enemy—"if you can't beat 'em, join 'em." But in the long-term, it is being *different* that gives an individual manager at least a fighting chance to win the battle for extra market return. Surely holding to a clearly differentiated strategy—and, for mercy's sake, keeping a tight lid on fees and other costs—to cope with the realities of index competition is better than just standing there and hoping, again in Mr. Micawber's words, that "something will turn up."

I acknowledge that not all fund managers subscribe to the new relativism. Indeed, some of the better managers in the field find it repugnant. A recent article in *MONEY* magazine suggests that it is caused by "aggressive marketing executives who see short-term numbers as the best way to attract new shareholders." One top strategist says, "that's the marketing side of the business talking, not someone with a fiduciary duty." Another asserts, "relative investing is ridiculous." Still another routinely consults what he describes as his 11th Commandment: "Thou shalt not do relative investing." Warns another, "relativity worked well for Einstein but has no place in investing."

Such mutual fund managers who elect to be different—and I wish that there were more of them—need to make it absolutely clear to shareholders that their returns will not closely track the quarterly returns, nor even the annual returns, of a market index, even as the managers should make it equally clear that their expectation is to outpace the market over the long run. The short-term nature of today's pervasive environment of comparisons is merely noise, a discordant element that ill-serves managers and financial markets alike. In this context, I reiterate a thought, courtesy of William Shakespeare, contained in my book. I describe the short-term noise in the market as "a tale told by an idiot, full of sound and fury, and signifying nothing."

In short, relativism is the triumph of process over judgment. I believe that it is possible for some managers to apply judgment borne of wisdom and experience to outpace the market over time, without assuming undue risk. The characteristics of those who do so will be individuality, training, experience, savvy, determination, contrarianism (or sheer iconoclasm), and hard work. The Puritan Ethic is not all bad! Importantly, they will limit the assets of the funds they manage relative to the market cap of the asset class in which they utilize their expertise, and relative to their proclivity to actively trade the portfolio rather than analyze, buy, and hold.

Some successful managers, rather than being concerned with short-term relative risks, will run fully invested equity positions to capitalize on the fundamental long-term opportunities of equity investing. Others will succeed simply by investing with the courage of their convictions, rather than slavishly relying on short-term standards, and holding cash reserves when they judge market risk as excessive. Both groups will manage their funds at reasonable costs, allocating their fee revenues toward human talent and investment productivity, rather than engaging in marketing profligacy designed not to improve investment returns for fund shareholders, but solely to advance the manager's own profitability.

In short, to be successful in a world in which indexing and quantitative strategies will become increasingly pervasive—and fully competitive—the successful traditional investment manager must serve the client's interest . . . first, last, solely.

To conclude, I rely again on Charles Dickens, this time in *A Tale of Two Cities*: "It was the best of times. It was the worst of times." It has been the best of times for the stock market, a 15-year bull market of unprecedented magnitude, creating happiness beyond measure. But it also has been the worst of times (though it is hardly perceived as that . . . yet), creating misery for the average mutual fund manager, who has lagged the S&P 500 Index by an unprecedented annual margin of nearly three percentage points—surely less than a ringing tribute to professional management. Looking ahead to a new century, the mutual fund industry must be challenged to serve its clients much more effectively.