Defining Investment Success . . . And Achieving It

Remarks by

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We meet today during troubled times. As *citizens*—of America or Australia, or any other nation—we all struggle with issues of war and peace, of governance and anarchy, of world-wide terrorism and nuclear proliferation, of poverty and plenty, and of economic stability and growth. At the same time, as *investors* we must deal with global equity markets which are at best fully valued and global bond markets with interest rates at levels that virtually assure returns over the intermediate term (say, the next ten years) that are well below those we have enjoyed over the past three decades. During my 53 year career in the world of investing, the challenges to developing successful investment strategies have seldom been greater.

But no matter what the challenges, *invest we must*. In a sense, investors must simply put on blinders and achieve whatever success is possible. When I visited Australia, I came to know your Trustees' commitment to super fund members and your dedication to achieving success on their behalf. I also know what a competitive bunch you are—whether on the sporting field or other fields of endeavor. You want to win. So do I!

Yet what *is* investment success? What is winning? Is it a return that exceeds the inflation rate by a high margin? Is it a higher return than one's peer super-funds? Is it a return high enough to fund one's liabilities in the case of a defined benefit plan, or meet members' reasonable expectations in a defined contribution plan? Certainly by anyone's measure, earning returns that accomplished all three of those goals would be deemed a success.

Alas, however, those two eternally elusive taskmasters, the stock market and the bond market, would be smiling at those measures of success. The financial markets are ill-correlated with inflation; they deal with your fund and your peer funds evenhandedly; and, unless they are wondering just how on earth your fund incurred such huge, long-tailed liabilities, these market taskmasters are laughing at the temerity of those who think that the funds they manage can somehow be expected to automatically provide returns that are adequate to meet the needs of their members.

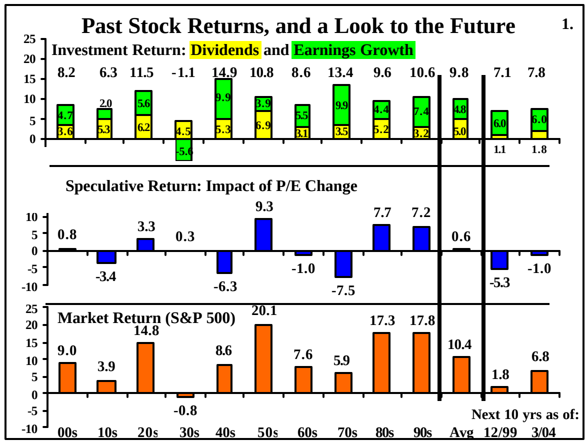
No, the hard reality of the financial markets requires us to accept whatever returns stocks and bonds are generous enough to deliver. If those returns are not adequate, we have to choose among these three options: (a) getting "smarter," adding value—"positive alpha"—by market timing, by picking superior managers, or by using alternative investments; and/or (b) increasing the amount of our plan contributions; and/or (c) reducing the benefit provided by the investment pool that we accumulate.

So our first task is to establish some rational expectations about the returns that stocks and bonds might earn in the future. I have found that the best basis for developing such initial expectations is *not* by poring over historical returns, and certainly not by pouring them into a giant Monte Carlo computer simulation. Since there's no evidence that the past is prologue in the stock market, we should look to the factors that determine *why* past returns were what they were, and appraise their probable dimensions in the years ahead. (In this exercise, I'll be using US stocks and bonds, but the methodology is equally valid for the Australian and other global markets.)

Realistic Expectations for Stocks

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." It is the simple combination of these two factors that establishes the returns of both the stock and bond markets. In the stock market **(Chart 1)**, what Keynes called "enterprise" I call *Investment Return*; and it consists of just two elements; the initial dividend yield 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 were to rise from 15 to 20 times over ten years—a 33%

increase—it would add 2.9 percentage points to the annual Investment Return.) In that simple formula—investment return plus a speculative return equals market return—lies the basis for developing reasonable expectations about the future.



The first element of Investment Return is the current dividend yield. The yield is a known quantity and today it is extremely low—just 1.8% for U.S. stocks, vs. an average of nearly 5% over the past century. As a result, we are starting with a handicap of more than three percentage-points versus the long-term historical Investment Return on stocks. The second element is earnings growth, where the century-long norm is 5%, albeit accelerating to 6% during the second half of the period. I'm guessing (I wish I could use a stronger word!) at 6% future earnings growth, based on my expectation that our GDP may succeed in growing at about that nominal rate in the coming decade. If I'm right, the future Investment Return on U.S. stocks will be in the range of 7% to 8%.

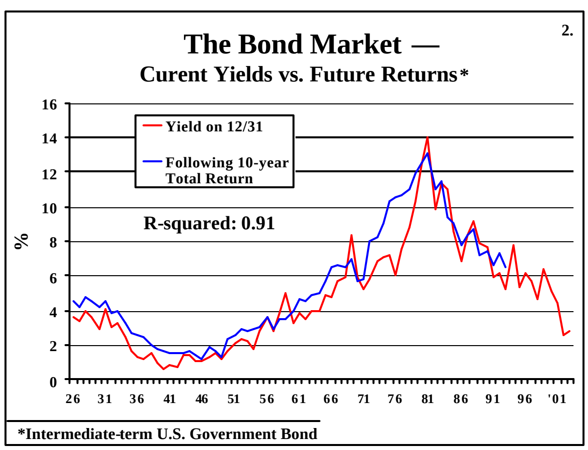
Developing reasonable expectations for Speculative Return is a much more fallible task. Over the past century, Speculative Return has contributed only about one-half of one percentage point to the 10% annual return provided by U.S. stocks. Yet as price-earnings multiples surged back and forth—from a low of eight times to a high of 35 times—the affect of Speculative Return over interim decades was just as *pronounced* as it was *sedate* over the full period. Indeed, the 18% annual return that the Great Bull Market favored us with during the 1980s and 1990s was built on a sort of ordinary Investment Return, buttressed by a huge Speculative Return of roughly 8% per year for an unprecedented two consecutive decades.

Clearly, speculative return comes and goes in the short run. With our stock market now selling at a p/e ratio of 18, (using projected operating earnings of $60 for the Standard and Poor's

500 Index). Rely on those earnings as you will, for they are the *operating* earnings, not the *reported* earnings net of non-recurring write-offs that seem to recur with consistency. I foresee no reason for the p/e a decade hence to rise, and thereby enhance the Investment Return. If the p/e were to decline over the next decade to, say, 16 times, that would actually subtract about a percentage point of return annually, reducing our reasonable expectations for a 7%-8% rate of Investment Return to a total return on stocks in the range of 6%-7% annually.

What About Bonds?

So let's use a range of return on stocks of 6% to 8% over the coming decade. If that return doesn't seem overly generous, one must ask: *Compared to what?* Bonds are the traditional alternative to stocks, and projecting future bond returns is relatively simple. Why? Because the ten-year total return on a bond is determined primarily by its Investment Return—the stream of income it delivers over the decade. **(Chart 2)** As a result, the returns on bonds earned over the past century are irrelevant in establishing reasonable expectations. Rather, it is the current interest rate—the rate on the very *day* on which you do your calculation—that provides the most reasonable expectation for the future return on bonds, with the correlation between the initial yield on bonds and their subsequent ten-year return a remarkable 0.91.



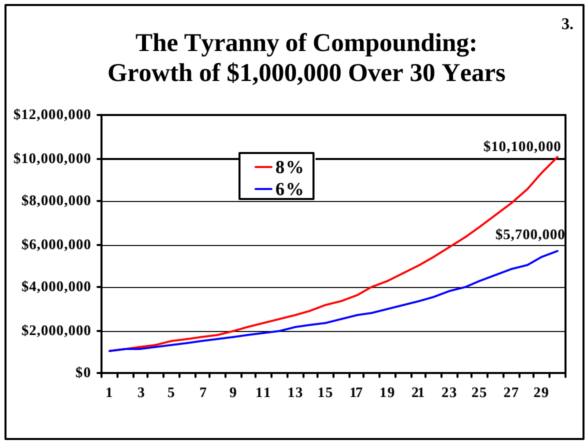
This conclusion about coming bond returns clearly reaffirms Lord Keynes' concept of enterprise return, "the yield on assets over their entire life." During the coming decade, of course, interest rates will rise and fall, and Speculative Return will play its games. But as Speculative Return inevitably wanes over the years, so Investment Return waxes, and finally dominates. With today's yield-to-maturity on a combined intermediate U.S. Treasury/investment-grade corporate portfolio at about 4½%. (It would be nearly 6% in Australia.) So we should expect bond returns in the 3½% to 5½% range during the coming decade—an equity premium of, say, 2.5%, somewhat lower than the long-term norm.

Who Actually Earns the Market's Returns?

Whatever the case, it seems difficult to escape the conclusion that we are looking ahead to a decade of lower returns in the financial markets of the U.S. and around the globe, albeit a decade in which equities have the potential to provide a significant return premium over bonds. But whatever returns the stock and bond markets are generous enough to provide, they are not *real* world returns but the *theoretical* returns, *before* the deduction of investment costs. *Please don't make the mistake of thinking you—at least not as a group—will actually earn those returns*.

Of course you know that 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 as well as, in Australia, the tax costs of turnover—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, then, is a *zero-sum* game; beating the market *after* costs is a *loser's* game. *And 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 very reason that the managers as a group are destined to fail at the task.* In short, achieving a positive Alpha of 1% is no easy task, and if it comes at a 1% cost, it nets out to zero.

Do investment costs matter? You bet they do! And they matter most when they are compounded over time. So pension funds, endowment funds, and foundations—all institutions all with notably long-term, indeed in a sense perpetual, investment horizons—can hardly fail to consider the role of costs. For just as the *magic* of compounding *returns* over the long term carries investment values to almost unimaginable heights, so the tyranny of compounding *costs* results in an almost equally unimaginable deterioration in these returns. Over 30 years, for example, each $1,000,000 compounded cost free in an 8% market grows to $10,100,000, compounded 6% after costs, it grows to just $5,700,000. **(Chart 3)** So a major part of investment success can be defined as capturing the maximum possible portion of the returns that the financial markets deliver. The costs you incur, indeed, may well represent the difference between success and failure.



Defining Success . . . and Achieving It

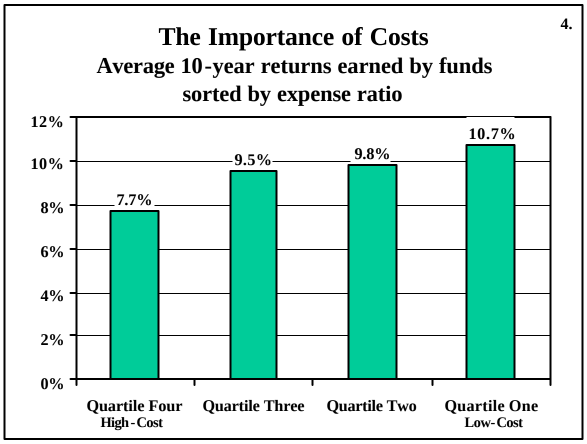
One need only to look at the US mutual fund industry to see the powerful relationship between returns and costs. During the past decade, while the Standard & Poor's 500 Stock Index delivered a 10.6% return, the average equity mutual fund delivered a return of 8.7%,[1] a gap of nearly two percentage points that is largely related to costs.

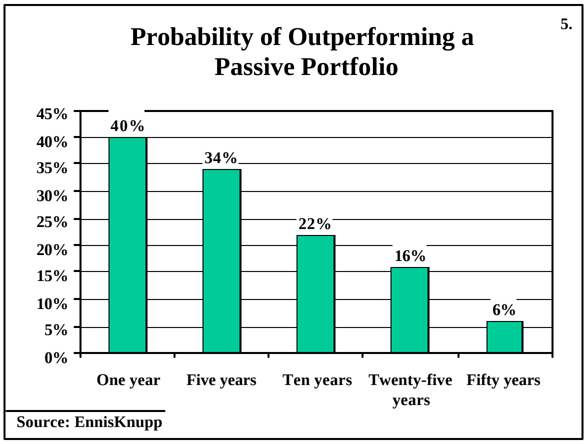
This is not a random pattern. Quartile by quartile, the higher the cost, the lower the returns: Return of highest-cost quartile, 7.7%, next quartile, 9.5%, next, 9.8%; lowest-cost quartile, 10.7%, a difference of fully three percentage points from the highest to the lowest. **(Chart 4)** Step by step, as costs declined, returns rose, and it happened, with remarkable consistency, irrespective of investment style or size of market-capability—a 40% enhancement in annual return, simply by doing your manager fishing in the low cost pond.

Now most institutional investors pay much lower costs than do mutual fund investors, as I'm sure your super funds do. But the pattern holds, and the long-term penalty of costs vastly diminishes the share of market returns a fund earns. A study by Chicago pension consultants EnnisKnupp calculated that even if a pension fund incurs all-in costs (fees, transactions costs, etc.) of as little as ¾% per year more than a passive portfolio, there was only a 40% chance of the

[1] The 9.4% return reported by Morningstar has been reduced by 0.7% to account for the estimated impact of sale charges and survivor bias. Costs include expense returns and estimated transaction costs.

active strategy outperforming the passive portfolio in a given year. And as costs took their toll, the odds quickly diminished—34% after five years, 22% after ten years, 16% after 25 years, and 6% of managers win over 50 years. **(Chart 5)** And *that* is why US pension funds have moved so heavily toward low-cost passive strategies aimed at tracking broad stock market indexes. With but a 6% chance of success of beating the market, small wonder that capturing the market return seems the paradigm of success!

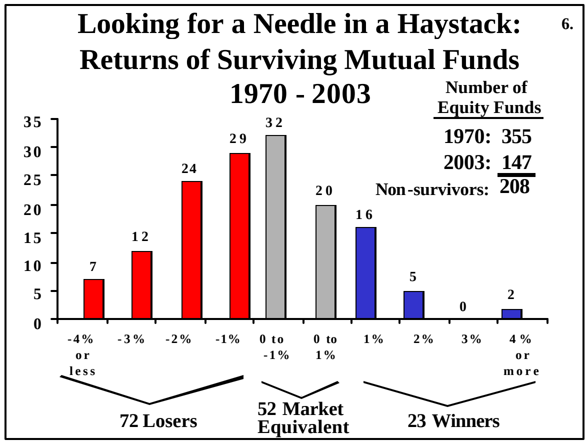




Picking Winning Managers

I'm sure most of you believe that you can select managements that will add value over and above the costs they incur—and actually earn a net premium over market returns. Of course it's possible for some super funds to achieve this goal. But not all. For there are powerful odds against doing so over the long-term.

Some idea of the magnitude of the task can be seen in the U.S. mutual fund industry. Selecting truly superior performers is like looking for a needle in a haystack. **(Chart 6)** Of the 355 U.S. equity funds in 1970, 60% have disappeared, with only 40% remaining today. Only seven of the surviving funds (2% of the total) beat the market by more than 1% per year, including just five that beat it by a modest but statistically significant two percentage points, and only two by more than four. Significantly, one of those funds has long since rested on its laurels, having experienced a full decade of sub-par returns. This evidence suggests that instead of looking for the needle we call a manager with positive alpha, one should consider simply buying and holding the market haystack.



No one can fault a super fund manager for trying to select the best managers. The question is *how* to do it. We know—or we *ought* to know—that picking a manager based on past performance is a fool's errand. Consider the relationship between the past and future performance of U.S. mutual funds during the past decade, and the results are stunning. Of the 255 funds in the fund in the top quartile during the first half of the decade, only 13(!) ranked in the first quartile during the second half of the decade. Ironically, of the 255 funds in the bottom quartile in the first period, fully 130—more than half—had leaped to the top quartile in the second. **(Chart 7)**

Do Mutual Fund Records Persist? 7.

Performance of 1,022 funds over two five-year periods, ending 1998 and 2003

Sorted by average annual return

First Period Quartile	Second Period Quartile 1Q	2Q	3Q	4Q	
1Q	5%	18%	37%	40%	100%
2Q	12%	32%	27%	29%	100%
3Q	32%	27%	25%	16%	100%
4Q	51%	23%	11%	15%	100%
	100%	100%	100%	100%	

You could conclude—but I wouldn't!—that you should select the poorest performers and then just wait for RTM (reversion to the mean) to do its work. But the past decade was an unusual period, with growth strategies dominating the first five years and value strategies dominating the second. A more valid test might be comparing fund performance during the past decade with performance during the prior decade. This comparison reaffirms that winners don't have much ability to repeat, but that losers (often weighed down by excessive costs) tend to stay where they were.

There were 258 funds in this 20-year comparison, and of the 64 top-quartile performers in 1983-1993 only 31% repeated in 1993-2003. (Chance alone would dictate that 25% repeat.) On the other hand, in the bottom quartile, nearly 40% of funds in the first period remained there in the second, with 26% moving into the top quartile. As you look at the matrix showing these returns, it's difficult to feel any sense of confidence in relying on past performance to select managers that can repeat their past success. **(Chart 8)** Yet while superior performers clearly come and go, high costs go on forever.

Do Mutual Fund Records Persist? 8.

Performance of 258 funds over two ten-year periods, ending 1993 and 2003

Sorted by average annual return

Second Period Quartile

First Period Quartile	1Q	2Q	3Q	4Q	
1Q	31%	25%	25%	19%	100%
2Q	25%	29%	26%	20%	100%
3Q	18%	31%	28%	23%	100%
4Q	26%	15%	21%	38%	100%
	100%	100%	100%	100%	

For Australian super funds, the challenges of selecting winning managers for the *future*—anyone can select managers who have done well in the past—are even greater when you consider the amount of organizational change that has characterized the domestic money management business in the last decade and the amazing fact that the average tenure of top investment managers in the Australian business is only three years. Added to this is the amazing selection bias problem your industry faces given the rise in the number of boutiques and the tendency of your funds management industry to attract international managers.

If You Don't Like Market Returns, Reach for the Moon

Of course, it's especially tempting to reach for higher returns if the outlook for returns on stocks and bonds is as subdued as I have suggested today. But how different is reaching out for higher returns by taking greater risks 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, in the U.S. at least, 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 Peter Bernstein's advice, 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 (as most investors think they are!), 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. There is a huge premium on selecting the "right" hedge funds. (Think of Long-Term Capital Management; think of the 700 hedge funds that reportedly folded last year.) Yes, it's possible to diversify by owning "funds of hedge funds," but adding extremely broad manager diversification plus a whole other layer of costs on top of the enormous costs of hedge funds themselves makes the performance hurdle all the higher to leap. For example, in the US, the average (and there are almost 400!) fund of hedge funds provided an annual return of 6.5% over the past three years, not far above the 5.5% return earned on a 60/40 balanced portfolio.

What is more, as money flows into 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 arbitraged away, even as yesterday's successful managers are flooded with money that precludes their repeating prior achievements. However successfully some managers have implemented these alternative asset strategies have been implemented in some large U.S. universities, we would all 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 total stock and bond market must be the absolute standard, there is *no* investment strategy that meets that universal imperative. Hedge funds, however mystical, are simply collectors of stocks and bonds using focused strategies and often short-selling. As a result, they are largely *management*-dependent, while traditional institutional portfolios are largely *market*-dependent. So proceed at your own risk.

Wrapping Up

So as you seek investment success, realize that it's never given to us to know the returns that stocks and bonds will deliver in the years ahead, nor the future returns that will be achieved by alternatives to the policy portfolio. But I take heart. For all the inevitable uncertainty midst the dense 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 *specific-security* risk can be vastly diminished by diversification, and that both *manager risk* and *style risk* can be eliminated by indexing, so that only *market* risk remains. That risk seems quite large enough, thank you!
- We *know* that costs matter, and overpoweringly in the long run, and we know we must minimize them.
- We *know* that neither beating the market nor successful market timing can be generalized without self-contradiction. What may work for the few cannot work for the many.
- 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 traditional pension portfolio.
- Finally, we *know* what we *don't* know. While we can never be certain how our world will look *tomorrow*, and know even less about how it will look a decade hence, we also know that *not* investing is doomed to failure.

Yet our task remains: Earning for our plans and our members their fair share of whatever returns that our financial markets are generous enough to provide. And that, to me, is the ultimate definition of investment success.

I happen to believe that the greatest probability of investment success lies in highly-diversified, low-cost *all-market* index funds. But 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 traditional 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*!

Your task is a worthy one, and I hope I've clarified it in my comments this afternoon. Your commitment to serving your members will carry the day. When I visited your wonderful homeland five years ago for the first time in my long life, I couldn't help thinking of how my lucky stars in the Northern Hemisphere have positively affected my life and career. I know that the stars of your Southern Cross will do the same for you.

END

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