Overview: A Fifth Point of Inflection

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CFA Institute Conference Proceedings, 2004

At the 2003 AIMR (now called CFA Institute[1]) Annual Conference, I gave a presentation in which I discussed what I saw as four points of inflection in the investment management industry: the demise of soft-dollar research, the reduced role of indexing, the escape from benchmarking and with it a greater reliance on absolute returns, and the impending death of long-only as a conventional strategy.[2] Clearly, these points of inflection were the focus of the presentations at the February 2004 conference -"Points of Inflection: New Directions for Portfolio Management" - on which this proceedings is based.

The Four Points

The authors in this proceedings have taken the four points of inflection I proposed in 2003 and looked at them with their own critical eyes. Paul McCulley makes some very profound observations. He describes the U.S. political economy as an "uneasy marriage between democracy and capitalism" and then illustrates how history has shown where the inflection points occur between the oscillating dominance of the competing forces of democracy and capitalism.

Addressing the "point" of the long-only constraint, Richard Ennis relates how greater flexibility can be introduced into policy portfolios not only by eliminating the long-only constraint but also by using a comprehensive "master manager" approach that, in part, separates how investors earn the return of the policy portfolio (beta) from how they seek to exploit security mispricing (alpha). Similarly, Laurence Siegel sees portfolios as being composed of a beta component, which is broad asset class exposure, and an alpha component, which is excess return achieved through active management. He cautions that if investors are hiring active managers, presumably because they believe these managers have real skill or the ability to deliver alpha, then they ought to be sure that they are paying for true alpha and not beta. Martin Leibowitz expands further on the policy portfolio issue and uses investor behavior as evidence supporting the need for a more fluid, adaptive policy portfolio that is responsive to discernible changes in the market.

Robert Arnott examines the long-term return outlook (for both stocks and bonds) and finds that it is not a rosy one, nor is the outlook for the equity risk premium. But despite this grim outlook, he sees several ways for managers to improve returns. In the same vein as Arnott, Jeremy Siegel looks at the longrun equity risk premium. Siegel believes that based on various indicators, the future equity return outlook is not as grim as suggested by Arnott and still offers a reasonable risk premium over bonds.

Finally, Barton Waring discusses what he believes to be the characteristics of successful active managers of the future: They will have skill in forecasting alpha, optimize their portfolios on the active efficient frontier, be moving away from using the longonly constraint, and have high breadth, good portfolio construction processes, low transaction costs, and stringent risk controls. And Gary Gastineau picks up on the "point" of indexing and says that although indexing has problems, the problems are not insurmountable and can be remedied by doing such things as adopting silent indexes and, yes, even using elements of active-management strategies.

[1] Effective 9 May 2004, AIMR changed its name to CFA Institute.
[2] For a printed version of this talk, see Peter L. Bernstein, "Points of Inflection: Investment Management Tomorrow," Financial Analysts Journal (July/August 2003):18-23.

A Fifth Point

I am grateful for the deep thought that the authors in this proceedings have given to my original four points of inflection. I have been mulling over these points myself for the past year and see another important topic that I want to expand on that draws from the four points of inflection and that will ultimately lead me to a fifth point centered on the question: How efficient is the market? That is:

- Although there is a mass of empirical data suggesting market efficiency, is the market as efficient as it appears?
- Why is the market so hard to beat? Certainly, nobody thinks it is easy.
- Why do so many smart people chase one another's tails? Everybody is trying to get into the same act.
- Do we know what we are measuring when we say "beat the market"?
- How much active risk should active managers take?

These are big questions, and I will try to answer them. But my main conclusion is that the whole business is a lot more complicated than the studies of market efficiency, from Eugene Fama on up, would lead one to believe. I conclude, however, with a strong note of hope: There is gold in them thar hills that managers are not mining. But the interesting question is: If there is gold in the hills, why are managers not mining it?

The Open-End Format

I take my text for this sermon from a recent National Bureau of Economic Research working paper by Jeremy Stein of the Harvard economics department called "Why Are Most Funds Open-End? Competition and the Limits of Arbitrage."[3] This article is a must-read. Stein asks the basic questions: Why are most funds open-end, and why are most investment management contracts yearly? I will cite just a few words from Stein's article:

> The open-end form imposes serious constraints on would-be arbitrageurs. In particular, being open-end exposes arbitrageurs to the risk of large withdrawals if they perform poorly in the short run. This risk in turn makes it dangerous for them to put on trades that are attractive in a long-run sense, but where convergence to fundamentals is unlikely to be either smooth or rapid. (p. 2)

If the open-end format makes it so dangerous to put on trades where the convergence to fundamentals is unlikely to be either smooth or rapid, then why is the open-end format so prevalent? Almost all mutual funds are open-end, and almost all investment management contracts run no more than a year. Stein suggests that clients and shareholders are concerned that the managers they select will turn out to be either incompetent or dishonest and thus clients want to be able to get their money out if they are dissatisfied. Clients want to be sure that they have that option. So, mutual funds are open-end and contracts are short term. But is that the true reason that the open-end format is so widespread?

Stein says in this view the prevalence of openend funds represents a socially efficient outcome because clients can get their money back if they are unhappy with performance or if they do not trust the manager. But he says this is not his view, and after reading his article, it is not my view either. He says the end result may be a degree of open-endedness that is socially excessive, and he then sets forth the following hypothesis: The gains for being able to undertake longer-horizon trades in a closed-end form should outweigh the potential losses that come from being unable to control wayward managers. That is, long-term contracts that involve

[3] Jeremy C. Stein, "Why Are Most Funds Open-End? Competition and the Limits of Arbitrage," National Bureau of Economic Research Working Paper No. w10259 (issued in February 2004). This article can be found at www.ssrn.com.

locking up money may produce better overall returns, better results, even though clients cannot control a wayward manager.

Locking up money gives managers the opportunity to undertake longer-horizon trades, what Jack Treynor in a wonderfully simple expression once called "slow ideas." If managers can earn more significant alphas by making longer-term bets, then why does the investment management fraternity have such a hard time persuading people to let them manage money that way? If a manager went to one of his or her clients and said "we would like a five-year contract," what are the chances the client would say that is a great idea? None. The closed-end fund business is a tiny portion of the whole mutual fund area. People want the flexibility of the open-end.

Why the Open-End Format?

Why should it be that people want the open-end format? The answer, ladies and gentlemen, is that it is not those among you who are clients who are blocking the outcome of longer-term contracts but those among you who are managers. You are the ones who are blocking it. How can that be? Let me trace the process by using a thought exercise in an imaginary world where all investment management arrangements are closed-end. The client puts the money in and cannot get it back out for a given period of time, and for a closed-end mutual fund, that time is never-no withdrawals of funds under any circumstances; the funds are absolutely locked up. This is a world where nobody ever heard of open-end.

Among all these closed-end arrangements are a few managers who are really good and are making alphas like crazy. Imagine one of these firms in this closed-end arrangement with 10 successive years of statistically significant alpha. The firm's employees sit down to have a champagne lunch to celebrate this occasion, and the firm's president says: "Hey, we are passing up something. We are so good at this, and we are just managing this one limited pot of money. We should open it up and let more people bring money to us. It will be wonderful. We will have a tremendous inflow of money instead of this limited pot, and we will make lots of clients rich in the process. So, why are we sitting with this closed-end arrangement? Let's open this thing up."

Once one firm goes open-end, then everybody follows suit. The really good firms will be the first ones to open up because they know they will attract money. The slackers, the firms that cannot create alpha, will also have to go open-end because they would be identified as poor performers if they did not go open-end. The inevitable result is that asset gathering becomes the mark of success. And welcome to the world of today.

Consequences of the Open-End Format

In short, it is managers who open the funds up. And this result has major consequences for the way managers manage money and what happens to their clients. Managers have put themselves in the position of the sorcerer's apprentice, who thinks he has found a great form of magic but soon the magic is giving the commands instead of the apprentice. Those of us who manage money in open-end formats-either an open-end mutual fund or a oneyear contract for management-are stuck with all kinds of problems. The open-end really has two ends: one where money comes in and the other where money goes out just as easily. As a result, managers are tied much more tightly to short-term strategies than they might like because they cannot persuade their clients to wait for the period of time that is required for a longer-term strategy to work out. Anybody who has managed money knows that feeling. Do you want to be underweight small cap when small cap is hot? Do you want to be overweight tech stocks when the bottom is falling out of tech stocks? Of course not. Contrarian strategies are very risky for managers, not only in terms of returns over the short run but also, more important, in terms of fickle clients or shareholders.

And it is not just managers who feel this kind of heat but also chief investment officers of institutions, foundations, endowment funds, and pension funds. They have to deal with investment committees and people higher up. If in any one year the Yale endowment fund is down 10 percent and the Harvard endowment fund is up 10 percent, David Swensen is going to be on the hot seat. In the January/February *Financial Analysts Journal,* Louis Chan and Josef Lakonishok say that value investing, or contrarian investing, earns a premium that is not due to higher risk in those kinds of companies, as Eugene Fama has suggested, but that is due to, and I quote, "behavioral considerations and the agency costs of delegated investment management" (p. 71).[4] This is what Stein is talking about: Managers are reluctant to take strong contrarian positions for fear that they will lose business, that funds will leave. Mark Kritzman wrote in *Economics & Portfolio Strategy* "even with perfect knowledge of expected return and distributions around them, annual volatility can be very wide if you make concentrated bets. And concentrated bets are where the big alphas reside."[5]

The fear of being wrong and alone is a very powerful one. Bill Miller, the miracle worker at Legg Mason, had compound returns of 28 percent a year from 1992 to 1999, but when the market turned down, he lost $1 billion; out went 12 percent of the assets under management, despite this proof that he had some kind of portfolio manager magic. Suppose Bill Miller had been able to go short in 1999 with the open-end format. How much money would he have lost? A pile of assets would have gone out before the year was over. If the focus is not on the short run in the management of money, why have mutual funds averaged 75 percent turnover for years, and even higher just recently? If the focus is not on the short run, why is minimizing trading costs so important? If a manager is turning over his or her portfolio almost once a year, then trading costs are enormously important and Plexus and other such firms are getting rich helping managers reduce their trading costs. If the focus is not on the short run, why are annual deviations from benchmark returns such an important element of client and consultant relations?

Hedge Funds. All of this adds up to some of the fascination with hedge funds, where in most cases withdrawals cannot be made on demand and money can be locked up. Why is that? The better hedge fund managers understand that asset gathering is poison to good performance, so they compensate that lockup with outrageous fees that make them happy with an asset pool that grows only as a matter of return. As I suggest later, this arrangement reveals what a more successful client/manager contract might look like.

Until recently, the predominant trend has been that investors put their money in open-end mutual funds because doing so allows them a high degree of flexibility. But as a result, they are getting suboptimal performance. I think that all of us in this business should begin to think more realistically and more systematically about the costs of liquidity in terms of lower returns versus the premium return that might be earned from locking clients' money up.

Or, maybe we should think about it the other way around: Alternative investments have reached such a level of popularity that clients are willing to lock money up in less liquid investments, such as real estate and private equity. It is a new kind of arrangement, and investors are moving in this direction. The hedge fund phenomenon indicates that change is under way, and in time, this whole open-end model may shift. Thus, just as I suggested in my original points of inflection that long-only is a funny way to manage money when selling short is another opportunity, I am suggesting that using open-end formats and chasing short-term alphas is a "corset" on investment performance. If managers really want to try to earn alphas, statistically significant alphas, they have to have a broader horizon. The hedge fund business is an opportunity to try to take such a broader horizon. Not all hedge funds will do it well. There will be bad performance in the hedge fund area. But hedge funds have created for themselves an environment in which they can make decisions with much greater freedom than the conventional manager can, and that is the kind of environment that I would like to see on a

[4] Louis K.C. Chan and ,Josef Lakonishok, "Value and Growth Investing: Review and Update," Financial Analysts Journal Qanuary/February 2004):71-86.
[5] Economics & Portfolio Strategy (New York: Peter L. Bernstein, Inc., 15 January 1998).

much wider basis. Managers thus need to liberate themselves from the short-run pressures that exist if they fall behind in any one year. There are longer-term inefficiencies that managers are not exploiting because of the consequences of being wrong and alone in the short run.

Examples. Following are two specific examples of what I have been describing. First, the most successful investor of them all, the one we all hold up as the icon, Warren Buffett, sits happily behind the impregnable wall of a closed-end fund. You can trade Berkshire Hathaway all you want, but you cannot invade the company's assets. Second, unlike managers of open-end funds, managers of overpriced dot.com companies had no hesitation in betting against the Internet bubble. They sold shares to the public right when the market was going through the roof, the equivalent of going short during those giddy years. The public gobbled up their shares. It was an almost riskless proposition for them. If they were wrong, they could just sit on the cash. But again, it was a closed-end format. The dot.com companies sold shares, the money came in, and the shareholders may have felt bad about it but they could not raid the company and get the cash back; the closed-end format can take a big contrary bet.

Market Efficiency. With all this focus on the short term because of the fear of losing assets withdrawn by fickle clients, no wonder that mispricings and related aberrations in the market are short lived. No wonder the empirical evidence demonstrates that alphas are few and far between. No wonder that alphas are thin when they do exist. No wonder we find so much volatility around the mean alphas. Stephen Ross in a lecture a couple of years ago said there should be no doubt whatsoever over whether the efficiency glass is half-full or half-empty. It is simply quite full. No wonder the market is so efficient in the short run.

Happy Ending

But recognition of this short-term focus and shortterm efficiency points to a happy ending that there *is hope.* Because of the open-end format, managers are not exploiting the mispricings that take longer to work out-Treynor's slow ideas. Consequently, the market may not be as efficient as the University of Chicago wants us to think it is. There is gold in them thar hills that we are not mining, and now we know why not.

The trend toward alternative investments and hedge funds shows that, on the client's side, views are beginning to shift. The notion of a lockup of funds is becoming a little bit more acceptable, as is the notion that it is fair enough to pay a higher fee because these managers resist the temptation to do asset gathering. Even absolute rather than relative performance is beginning to attract investors, which means liberation from the tyranny of benchmarks. So, some progress is being made toward a healthier format that is less short-term oriented and toward a greater opportunity to take risks, even over the long term-a fifth point of inflection. Welcome to the world of tomorrow.

When I think about the investment management business, I try to imagine what an investment contract with a five-year horizon, instead of a one-year horizon, would look like. I wonder how we can give the manager maximum leeway and still protect the client from incompetence and dishonesty. I do not have a final answer and have only begun to think about this problem, but perhaps one way to address the competence issue is to look at past performance. Past performance may not be a predictor of future performance, but it does say something about competence. In every study that I have seen, people who have a bad track record for five years are not about to start having a good track record. Somebody with a good track record can falter, but somebody with a bad track record does not work his or her way out of it. So, past experience does say something about competence. As far as dishonesty is concerned, even the open-end format does not prevent managers from stealing money from their clients. It offers *no* protection.

So, how about a five-year contract that the client signs, but the client can purchase options to quit at the end of any year, with the price of those options declining year by year? If a client wants to get out the first year, that option is very expensive. If the client wants to get out the third year, that option does not cost the client so much up-front. If the client wants to stay for the whole five years, the fee will be that much less.

So, I am talking about a five-year arrangement where if the client wants to get out sooner, it will cost the client. The idea is to give the manager the money for an extended period of time so that the manager is in a position to make longer-term bets than he or she could under the open-end format, where money can go out when the client chooses. That ability for money to come and go at will has to demand a price. If the client is willing to lock his or her money up for five years and does not buy the option, the fee is small. My firm is not a law firm, and we do not manage any money, so I leave the details to others to work out. But I hope more investors have the opportunity to seek alpha where it may really reside and not only in short-run horizons. Seeking alpha over the long term, rather than the short term, would be a fifth point of inflection for our business, for our clients, for research, for everything that we do, and this new format would be much healthier for investors than our present format.