The Winner's Game

Making your own plan is often quite rewarding.

Charles D. Ellis

The right investment program for any particular person can look very wrong unless the individual's utility values are understood. Here's a personal example.

My grandparents left $10,000 to each of their grandchildren in 1946. While the post-war economy boomed and the stock market rose strongly over the next 15 years, these funds were kept in a *checking* account. Even with 20/20 hindsight, I believe that was the right "investment" policy—for those directly involved.

My mother knew what she was doing and why. Her father was a country lawyer in Mississippi who went broke during the Depression—like every other lawyer in the Delta region. So, to stay at Northwestern University, my mother borrowed tuition from Kappa Alpha Theta, her fraternity (the term "sorority" was not yet used), and then spent the next 15 years typing students' papers at 10¢ a page and sewing little girls' dresses at $1 per dress to repay those loans.

My mother knew how important it was to have enough for college *in the bank*. She was determined her children could go to college, so she wanted to be sure we had enough of our own money to cover whatever we couldn't get in scholarships. She knew our inheritances would be enough to cover. To risk that assurance just to get more than we needed made no sense at all to my mother.

Why, you might ask, not at least put the money into a savings account? My mother had experienced the bank holidays personally and she had read the fine print: Our local savings banks reserved the right to wait 30 days

Charles D. Ellis is senior advisor of Greenwich Associates in Greenwich (CT 06831-5195).

before paying out a withdrawal—and my mother knew that banks could fail in less than 30 days. Thus our college savings were kept for 15 years in a checking account—so they could be withdrawn immediately if the bank looked shaky.

All things considered, would anyone think my mother's investment policy wrong? Not I. She understood the game and knew how to win.

THE LOSER'S GAME VERSUS THE WINNER'S GAME

Generically, a *loser's game* is any game, contest, or activity in which the ultimate victor is determined by the actions of the *loser.* These contests are not *won;* they are *lost.* Amateur tennis is a classic loser's game, because most points and most matches are not won. They are lost. You keep hitting balls back to me, but I double-fault or hit shots out or into the net until the set is over, and you are the winner. But you didn't control or determine the outcome by playing better; I produced the outcome by playing worse.

In a *winner's game,* the winner not only wins, but also causes his or her victory—as we see when watching the Williams sisters at tennis or Tiger Woods at golf.

The encouraging reality is that every investor can be a winner of the winner's game of investing, because there is no adversary who must lose in order for you to win. And the requirements for winning are all quite understandable:

- Know the resources available for investment.
- Understand the long-term spending objectives and obligations to be funded.
- Recognize the realistic nature and vagaries of the investment markets—particularly when Benjamin Graham's Mr. Market is out there trying to capture attention.
- Acknowledge the analytical capabilities and the emotional capacities of the particular investor at the times when rationality will be most serious challenged.
- Concentrate on determining the long-term investment policy *most* likely to achieve realistic long-term objectives and *least* likely to fail—or cause the investor to fail during the long interim period of investing operations, a time surely fraught with uncertainties, disruptions, and confusions.
- Adapt the long-term policy to real and significant changes in the investor's financial resources or long-term objectives, if and when they occur.

THE WINNING TRIANGLE

Most investors will benefit from the self-disciplining exercise of committing to writing their explicit definitions of all three parts of the winning triangle:

1. Current financial resources *for* investments.
2. Future financial objectives *from* investments.
3. The bridging strategy and investment operations designed to take the portfolio most effectively, efficiently, and reliably from here to there, from item 1 to item 2.

The challenge to the investment profession is becoming increasingly clear. The centerpiece of every long-term investment program is the most underdeveloped level of the game—Level One: Setting the policy normal asset mix.

Part of the benefit of a written program is the encouragement this discipline gives to our efforts to be rational and rigorous. Part of the benefit comes when we invite serious friends to review and critique our articulation and to offer any challenges they consider significant. And part of the benefit comes from carefully reviewing the written document regularly, typically once each year, to be sure it is as understanding as possible of ourselves and the markets.

LEVELS OF THE GAME

While most investors take investment services as a blended package, it is important to unbundle the package into separate levels of the game. In making investment decisions, there are five separate levels of decisions for each investor to make individually:

- *Level One:* Asset mix—The optimal proportion of, e.g., equities, bonds, private equity, for the policy normal of the investor's portfolio. This is where investment counseling usually concentrates.
- *Level Two:* Equity mix—Policy normal proportions in various types of stocks: e.g., growth versus value; large-cap versus small-cap; domestic versus international.
- *Level Three:* Active versus passive management—Deciding on the appropriate method of implementation for the policy normal mix of investments.
- *Level Four:* Specific manager selection (where most investors and most investment committees

concentrate their time and effort)—Deciding which firms will manage each component of the overall portfolio, firing the most disappointing, and hiring the most promising.
- *Level Five:* Active portfolio management—Changing portfolio strategy, security selection, and trading.

Investors should recognize that the game of investing is not necessarily a single, bundled package, but can be divided into separate parts or levels and that investors can engage in or ignore each level of the game. And investors are free to choose. This freedom of choice is truly splendid because investors can avoid losing the loser's game on Levels Four and Five, and can concentrate on winning the winner's game on Levels One and Two.

As human beings, particularly if we are successful in other parts of our lives, we are notoriously unable to accept the obvious reality that, on average, we are average, and that our normal experiences will usually be about average because we are, as a group, captives of the normal distribution of the bell curve. It amuses us that Lake Wobegon's children are all above average, yet studies all the time show we think we are above-average drivers, above-average parents—and above-average investors. And we do tend to take it personally when our stocks go way up or go way down, even though, as Adam Smith admonishes, "The stock doesn't know you own it."

Every investor should recognize the powerful potential impact of luck—not good luck, but bad luck. We can all live through good luck. But bad luck—the apparently random occurrence of adversity—is equally prevalent, and its consequences can be far greater.

LEVELS ARE SEPARABLE

Knowing that the levels of the game are separable liberates the investor (or the investor's investment manager) to decide whether to be active at each separate level. At least implicitly, the freedom of choice presents a responsibility to choose, because not to decide *is* to decide. Yet the secret to success, as experience demonstrates again and again, is not playing the loser's game on Levels Four and Five, but instead concentrating on the winner's game on Levels One and Two.

Experienced investors know that the high-to-low order of cost is the mirror opposite of the order of value:

- The most costly and least value-adding level is Level Five with all its active trading—the black-hole vortex at the center of the loser's game.
- The least costly and most value-adding level is Level One—determining the optimal asset mix to achieve an investor's realistic long-term goals. Every investor can determine the realistic long-term objective most appropriate to that particular investor's present financial circumstances, capacity for absorbing risk, and future goals and objectives.

INSTRUCTIONS

Tommy Armour, the great teaching professional in golf, focused on two key propositions:

- Hit the shot that makes the next shot *easy.* (In flying, the equivalent thought is that "there are old pilots and bold pilots, but there are no old, bold pilots.") Armour urged players to stay within their zone of competence, to play within their own personal game, and not to play against themselves.
- Noting that roughly half of all shots in golf are putts, Armour urged his students to concentrate their practice time on putting—not on the driving range. (Willie Sutton had the same idea about banks: "That's where the money is.")

The sad irony in the investment profession is that most practitioners and most clients devote most of their efforts to Level Five and incur most of their costs competing against an unbeatable array of contending forces: the institutional investors who are too many, too well informed, too talented, too quick to react, too intensely striving to win ever to be beaten over any long period by anything like enough of a margin to cover the costs of playing the game on Level Five.

And the record on Level Four is also quite discouraging. While institutions, with all their expensive advisors and consultants, may experience somewhat less harm by changing investment managers, the record for individual investors in mutual funds is unsettling. Over the long run, while mutual funds underperform the market by a mercifully moderate amount, individual investors in mutual funds by changing funds, often at the wrong time, obliterate most of their mutual funds' returns:

Market rate of return	13%
Funds' rate of return	10%
Investors' rate of return[1]	2%

If you think it's bad enough that 85% of the positive return is lost on average, just think about how dreadfully the seriously below-average investor performed during this period. And consider the consequences of the average investor lagging by 10 percentage points in a market that averages only 8%, which may be our current most likely outlook, or in a three-year period when the averages were down 15%-20% per year.

MR. MARKET

The long-term passage through the *terra incognita* of future markets is sure to be accompanied by the uncertainties and disruptive challenges of that wily, disconcerting companion we cannot shake: Mr. Market.[2] Emotionally unstable, Mr. Market veers from years of euphoria when he can see only the favorable possibilities of industries, companies, and their stocks to profound pessimism when he's so depressed he can see nothing but trouble ahead.

Mr. Market persistently teases investors with gimmicks such as surprising earnings, startling dividend announcements, sudden surges of inflation, inspiring presidential pronouncements, grim reports of commodity prices, announcements of amazing new technologies, distressing bankruptcies, and even threats of war. These events come from his bag of tricks when they are least expected. Just as magicians use deception to divert our attention, Mr. Market's very short-term distractions can confuse our thinking about investments.

Mr. Market dances before us without a care in the world. And why not? He has no responsibilities at all. As an economic gigolo, he has only one objective: to be attractive. Mr. Market constantly tries to get us to do something—anything, but at least something—and the more activity, the better.

Explorers, pilots of single-engine planes, and ocean sailors all know that while adventure and achievement are what laypeople think about, the experienced practitioner's thoughts and actions are centered on the disciplines of defense—not running out of water, not running short of food, not getting lost, not getting frightened—because they know from experience that the essential foundation for a successful offense is a strong defense.

The best defense against Mr. Market's seductive tricks is to study stock market history—just as airline pilots spend hours and hours in flight simulators, practicing flying through dreadful storms, landing at unfamiliar airports, and dealing with mechanical malfunctions so they are well prepared to remain calm and entirely rational when faced with such situations in real life. (They also learn not to take events personally and not to become emotionally involved, knowing that surprises are not surprising: They are actuarial expectations on a bell curve.)

THREE REALITIES

As more and more individuals become responsible for the investment policy of their retirement assets, particularly via 401(k) plans, it is even more necessary to develop the methodology for formulating realistic long-term goals and policies that effectively integrate three realities.

The Reality of Current Resources and Probable Additions. We need to know the present value of likely additions to a portfolio (through savings or inheritance) that should be included in the present inventory.

The Reality of the Market's Most Likely Behavior. We need to recognize the market's unusual, but possible behavior during and over the period of investment. Two assumptions are eminently reasonable and easy to use:

- The long-term array of past market fluctuations will probably be reproduced over the long-term future.
- If the current level of the market is outside the normal range, the market level will regress toward the mean.

Most investors overemphasize the favorable possibilities, striving to maximize returns with a bold offense. These investors would be wise to change their orientation and reframe their approach to the period of investment—the fiscal bridge between their present and their future.

Most investors would benefit from giving more attention to their defenses, and to not losing. That's why:

- If mutual fund investors understood the total costs of switching funds, they would know to invest only in funds they truly intend to stay with —forever.
- If investors understood the costs of trading, they would at least slow way down.

All investors of course will experience uncomfortable fluctuations in the market. That's reality—and not a major concern. The real concern is with irreversible losses caused by overreaching for speculative possibilities; by taking market risks greater than our capacity to endure turbulence and maintain consistent rationality; by reaching for managers whose best performance is behind them and who are destined or doomed to underperform—with your money; and by going into debt.

The Reality of Future Objectives for Spending from Invested Funds. Most individual investors have some room for maneuvering and can adapt some of their future objectives to the changing realities of financial capacity, so it is often informative to categorize goals and objectives by degree of importance.

For instance, sustaining a given lifestyle is usually more important and less negotiable than is a large gift to one's alma mater. This is the sort of value weighting that incorporates utility into the assessment of investment objectives because happiness and peace of mind are not simple, quantitative measures.

(The difference between success and happiness is worth pondering. Success is getting what you want in life, while happiness is wanting what you get.)

How much regret will you feel if you end up with 20% over your goal? How much regret will you feel if you're 20% under your goal? Graham's great concept—the margin of safety—is essential for long-term investment success because it's not just the end-point that matters; the pathway matters too.

Charles Dickens articulated this reality as "Micawber's law": Income of £20 and expenses of £19 and 19 pence equals happiness, while income of £20 and expenses of £20 and tuppence equals misery. This is why most endowments now use a moving-average spending rule discipline of 5% after covering inflation.[3]

KNOW THYSELF

Yes, investors are right to be serious students of the markets, particularly the extremes that entice and ensnare, but markets are only part of the recommended curriculum. Know thyself is even more important, and all investors will want to recognize the central lessons of behavioral finance:[4]

- We believe in hot hands and winning streaks, and that recent events matter, even in flipping coins.
- We are impressed by short-term success, as in mutual fund performance.
- We are confirmation-biased, looking for and overweighting the significance of data that support our initial impressions.
- We allow ourselves to use an initial idea or fact as a reference point for future decisions even when we know it is just a number.
- We distort our perceptions of our decisions, almost always in our favor, so that we believe we are better than we really are at making decisions. And we don't learn; we stay overconfident.
- We confuse familiarity with knowledge and understanding.
- As investors, we overreact to good news and to bad news.

With all this going against us, it's no wonder that we get seduced away from concentration on the winner's game of investing and into the loser's game—particularly since Mr. Market is clearly one of the most entrancing seducers of all time. Investors—like dieters and teenage drivers—will be wise not to expect too much of themselves, particularly when superior personal behavior would be vital to achieving superior results.

If Mr. Market can't get you to be overly optimistic by showering you with good news and promises, then can he worry and even scare you with bad news and threats? We all have weaknesses, and Mr. Market knows where and when to push our buttons.

Risk tolerance differs for each investor. And the worst time to learn your risk tolerance—the limit to which you can absorb risk without experiencing the anxieties that produce irrational behavior—is when you are there for the first time or are without preparation. This is why fire drills make sense, and why investors will benefit from studying past market behavior, so they can estimate their own "what if" behavior and protect themselves from getting caught outside their personal comfort zone.

Utility likewise differs for each investor. Having $100,000 extra is not the reciprocal of being short by $100,000 any more than having an extra gallon of gas in the tank when you arrive at your destination is the reciprocal of running out of gas 16 miles from home. Each investor will benefit from an explicit understanding of his or her utility function.

Time—the Archimedes lever in investing—wants to be your helpful friend if you can be patient. If you invested $1.00 in the S&P 500 through the 1990s, you would have made $5.59. But if you missed just 90 big days in that decade, you would have *lost* money. And if you missed just 60 months out of the 75 years ending in 2000, your total return for that long, long period would be zero.

The obvious lesson: To get the long-term return, you have to be there when the market moves—and these best days or months occur when least expected.

EVERYONE CAN WIN

If everyone played the winner's game, it would be the ultimate positive-sum game. Here's why. For every investor, there is a best-fit long-term policy, and your following that best policy takes nothing away from any other investor. If all investors followed the investment policies that would be best for them, they would have no conflicts with any other investor's best-fit policies.

The only assumption behind this categorical statement is that investors differ in risk tolerances and in time horizon, and emotional capacities, and the consequences of just these two types of difference produce an almost infinite variety of combinations of risk restraints, investment objectives, and investment capabilities. For each set of variables, there is an optimal best-fit investment policy.

With the beginning and the ending reasonably well defined, the investor can then try to estimate the most probable and reasonable expectation for investments over the intervening time span to see how realistic it is to expect the starting funds to achieve the investor's objectives after experiencing that most probable investing experience.

If this three-part cut-and-try process works, fine. If the fund comes up short, the investor will want to consider saving more or limiting the aggregate goals. In an iterative process, the investor looks for the best combination personally of reduced objectives, or increased interim savings (or reduced interim spending), or higher market risk levels for the investment portfolio.

The really hard part about investment policy is not figuring out the best feasible combination. While it takes some time and analytical discipline, this part of the problem-solving is far from advanced science.

The really hard part is managing ourselves: our expectations and our interim behavior. Walt Kelly's Pogo puts it as "we have met the enemy and he is us." Most investors are too optimistic about the long run and much too optimistic about how well they will do compared to the averages, so they set themselves up for disappointment.

Even worse, most investors do harm to their longer-term investment results by trying and trying again to do better: changing managers and changing asset mix at the wrong time and in the wrong way. Disappointed by a few years of poor performance from managers they were attracted to by their good performance of prior years, they miss the recovery when the manager's type of stocks does well, and they catch the down-leg of the newly chosen manager whose results are simply regressing to the mean.

The record on market timing is even worse. Investors' self-destructive attempt to do better is shown starkly in the results of the mutual fund investor switching noted above.

Where can and should the individual or the institutional investor turn for counsel on the long-term investment policy that is right for that individual or that institution? Where would you send your mother's best friend? Where would you send the trustees of your alma mater? Where would you want your grandchildren to go for investment counseling? Is it really just *caveat emptor?*

If you find these questions difficult to answer, you may share with me the view that the investment profession has an important opportunity to develop capabilities in investment counseling that are comparable to our skills in market-making, and make them much more widely available.[5]

Three parts of investment policy are important:

1. Deciding the right asset mix for the particular investment fund.
2. Accepting and working with the reality that each investor's long-term gross returns for each asset class will very likely be "average" for that asset class—minus manager fees, taxes, and so on—and accepting the corollary reality that underperforming is much more likely than outperforming.
3. Sustaining policy commitments at market highs *and* at market lows, exactly when that rascal Mr. Market is doing his very best to do his worst.

The reality is that "roughly right" is all we can ever hope for on long-term asset mix, because even the most sophisticated investors must make their judgments on the basis not of facts, but on probabilistic estimates of two great uncertainties, markets and human reactions to markets, and without knowing the consequential leads and lags that will surely be part of the real world.

LOSER'S GAME: GETTING WORSE

The importance of investor concentration on winning the winner's game with sensible long-term investment policies is matched by the daunting realities of changes in the investor's environment that make the loser's game all the harsher and more forbidding. Changes in the way institutional portfolios are managed are substantial. And because they are simultaneous, they are compounding.

- Turnover of institutional portfolios continues to rise and is now over 100%. At this high rate of change, can anyone argue that this is serious long-term investing and not just informed speculation about how other investors will react to current reports and expectations?
- Institutional dominance of the stock market has been accomplished. The proportion of total public trading on the New York Stock Exchange has gone in 40 years from 10% to over 80%. That is, 80% of the shares you buy are being sold by, and 80% of what you sell is being bought by, an institution.
- All institutions are connected all the time with extraordinary sources of information. Thousands and thousands of historical databases can be called up, correlated, and examined instantly on a daily basis. Everybody has a Bloomberg.
- The biggest of the big are very big. The 50 largest and most active institutions execute half of all the NYSE transactions. And the smallest of these 50 institutional powerhouses pays Wall Street $100 million every year for services, so, naturally, they get amazingly fast first-call services of every kind every day.
- Over 10,000 analysts working at stock brokerages strive to ferret out data and information they can analyze and interpret—and deliver swiftly to the institutions, particularly the giants. One result: Most investment thinking is dominated by shared information, making it very hard for anyone to think independently of the crowd and to act independently.
- More and more institutions monitor quite closely how their portfolios match the index against which they will be compared by clients and consultants. And the comparisons are made at very frequent intervals, always quarterly and often daily.
- Managers have learned to hug the index because clients seldom fire a manager for slight underperformance, particularly if the personal service relationship is strong.
- Turnover among investment managers has risen to the point that one-in-four institutional clients fires a manager each year. Surely, this adds to managers' short-term caution.

Because the business consequences of the loser's game are becoming recognized by investment managers, they are moving toward the norm of hugging the index and charging full fees for managing high-turnover portfolios based on largely the same information—with little chance of outperforming competitors who are equally skillful, have equal access to Wall Street's central information, and are equally quick to respond to changing information or interpretation by buying or selling. The lions and the tigers are all running faster and faster in a circle. And they are turning to butter because the crowd is chasing after the crowd.

A LESSON FROM CHILDHOOD

Half a century ago, at Seaside Cemetery in Marblehead, Massachusetts, I was given a lifelong lesson in the advantages of not following the crowd, particularly when the crowd is most sure of what to do.

We were Boy Scouts, chosen to march right behind the Veterans of Foreign Wars and the American Legion color guard on Memorial Day in the parade that began at the Historical Society and wound up at Seaside Cemetery. There we were to stand at attention as the men aimed their rifles into the sky and fired the traditional 21-gun salute of remembrance.

We may have been chosen to show support for the VFW and the Legion, but as boys our real reason for being where we were soon became obvious. "Boys," said the Commander, "You will all stay behind this line because this is a solemn occasion. We are here to remember those who made the supreme sacrifice.

"Now, I know you're interested in the cartridges as souvenirs, so here's what we'll do. After the salute is fired, I'll pick up all the spent shells. You will stay right where you are. On my command, one-two-three, I will roll the shells toward you. As I let go of the shells on three, and not before then, you boys can run and get them."

The salute was fired. The shells were collected. The Commander faced us. We all knew what to do. Be first! We jockeyed anxiously for position, just behind the line, determined to dash out faster than the others. The Commander was ten feet away. We were ready.

Then it hit me. If everyone was determined to be first, it might be smart to be last. I decided to be different.

The Commander's hand swung back. One! Every boy was ready to pounce. Two! The Commander's hand swept forward on three, and the boys were off. The shells were bowled perfectly. Everyone was trying to be first, except me.

A few seconds later, having hung back, I'd picked up four shells that had rolled right under all the other boys and into the space where only I was looking. Into my pocket they went, and then I piled in with the others. After all, I might find another.

But that's not the point. The point is that when the opinions and behavior of others dominate a situation and its probable outcome, making your own plan is usually wise, always worth considering, and often quite rewarding.

Making your own plan is the best, and probably the only, way to win the winner's game. And it's easy if you can ignore that rascal Mr. Market and the crowd that follows him to play the loser's game.

ENDNOTES

[1]Data courtesy of John Bogle.

[2]Introduced by Graham [1949].

[3]The percentage was originally worked out by James Tobin of Yale to provide intergenerational equity by recognizing investment experience and new gifts and the impact of inflation. David Swensen [2000], has developed the most rigorous and complete articulation and implementation of solving for the three-way reality in management of the Yale University endowment. He explains this in *Pioneering Portfolio Management*.

[4]Zweig [2002] catalogues the ways our brains operate that may have been helpful in the Ice Age, but do harm to a contemporary investor.

[5]Vanguard has taken a leadership position in this realm by offering via the Internet a computer-based projection of future outcomes at low cost (a.k.a. Financial Engines).

REFERENCES

Graham, Benjamin. *The Intelligent Investor.* New York: Harper Collins, 1949.

Swensen, David. *Pioneering Portfolio Management: An Unconvention Approach to Institutional Investment.* New York: Free Press, 2000.

Zweig, Jason. "Are We Wired for Wealth?" *Money,* October 2002.