The Coffee Can portfolio

You can make more money being passively active than actively passive.

Robert G. Kirby

During recent years, there has been a gradual but steady increase in the use of index funds by institutional investors. This disturbs me, because I believe that superior investment research and management can produce consistently above-average results. Even beyond that point, however, I am also bothered by the wide, unquestioning acceptance of a form of indexing that appears to be seriously flawed. Nevertheless, despite these complaints, I do not disagree out of hand with those who adopt indexed investment programs.

We all know that, *in the aggregate,* professional money managers do not produce a return superior to that of a broadly based, unmanaged portfolio. We ignore the data that show that a few money managers have done consistently better, and a few others have done consistently worse. This means that we should not be surprised when an investor who has been a client of a poor money manager decides that he would be better off with an index fund. To beat the market is not easy. In addition to a good investment manager, the investor needs perspective, patience, and courage — qualities that do not abound in today's intensely competitive world. For many investors, institutional and individual, an index fund may well be the best kind of common stock investment program.

WHY INDEX? AND WHY NOT?

Perhaps I have a suspicious and cynical mind. Each surge in the popularity of index funds seems to follow a period during which the S&P 500 has been an excellent performer. Most index funds are not set up to avoid inferior performance; their purpose is to secure superior performance — just as when an investor hires a new investment manager with a great recent record. These are the wrong reasons.

Other investors adopt index funds for the right reasons. They believe that (1) the market is efficient in pricing assets so that it is virtually impossible to achieve consistently superior returns, and (2) the underperformance of professional money managers is the result of futile transaction costs. I disagree with these assumptions, but they support a position that is logical and makes sense. The question that completely perplexes me is why, with this sensible and logical approach to equity investing, these people then choose to replicate the Standard & Poor's 500, which (1) is in reality actively managed, and (2) does not represent the market?

WHEN IS PASSIVE ACTIVE?

In case you're shocked, let's examine these two statements. First, on the point of active management, maybe you can accuse me of splitting hairs, because turnover in the S&P 500 is small in comparison to that of most "active" money managers. Even modest activity, however, if it occurs year after year, produces a substantial cumulative change in the portfolio. In the past 10 years, Standard & Poor's has made several hundred changes, both eliminations and additions, in their portfolio, and these changes have created transaction costs for holders of S&P 500 index funds. Further, the changes are not the result of a formula that produces a consistent, predictable kind of alteration: They represent individual judgments of the Standard & Poor's staff, based on a combination of research and intuition, just as old-fashioned, active portfolio managers do it. Yet many people who are

well aware that the S&P 500 is a faulty index are unwilling to go to the trouble to re-educate the investors whom they represent. But assume you are a brave and responsible fiduciary. What should you do?

In my opinion, you have two alternatives. Which you choose depends on your reasons for pursuing an index fund to begin with. Do you believe that the market is efficient and you want to adopt a program that replicates the market, because that's the best you can do? Or, do you believe that traditional, active portfolio management incurs such high transaction costs that even the best money managers are unlikely to produce superior investment returns consistently? These are different reasons.

If you believe that a market return is the best an investor can hope for, you should pursue an investment program that will replicate the market, which is best represented by the Wilshire 5000 Stock Index. Clearly, it is impractical to use the actual Wilshire 5000. Such a program would drive both the computer and the trading department bonkers. The last 1000, or so, stocks in the index barely qualify as publicly owned and have about the same marketability as a 1961 Edsel. On the other hand, a tailor-made "Wilshire 1000" would represent 87% of the Wilshire 5000 and should be an acceptable proxy for "everything out there," providing true market results.

WHEN IS ACTIVE PASSIVE?

But, if you have decided that the greatest detriment to superior investment returns is transaction costs, then I have a novel solution. For many years, I have been intrigued with an idea that I call the "Coffee Can" portfolio. I suspect that this notion is not likely to be popular among investment managers, because, if widely adopted, it might radically change the structure of our industry and might substantially diminish the number of souls able to sustain opulent life-styles through the money management profession.

The Coffee Can portfolio concept harkens back to the Old West, when people put their valuable possessions in a coffee can and kept it under the mattress. That coffee can involved no transaction costs, administrative costs, or any other costs. The success of the program depended entirely on the wisdom and foresight used to select the objects to be placed in the coffee can to begin with.

As you might guess, I didn't write this article to suggest a better way for Efficient Market folks to improve their approach to passive investing. Rather, it is to provide help for investors who are concerned about the bite taken out of total investment returns by high and rising transaction costs. This problem has grown in recent years, as the focus on month-to-month and quarter-to-quarter investment returns has intensified. This pressure has been reflected in shorter decision time horizons by money managers and higher turnover.

If transaction costs are one of the main deterrents to superior long-term investment results — a point of view I embrace — why not have your passive portfolio represent the best possible portfolio, rather than a changing list of 500 stocks selected by Standard & Poor's? I suggest that you find the best investment research organization you can and ask them to select a diversified portfolio of stocks with the knowledge that the portfolio will not be re-evaluated or re-examined for a period of at least 10 years.

Having looked at a great number of portfolios over 30 years, I believe that about the maximum premium return that a money manager can expect to achieve in relation to an index such as the S&P 500 would be three percentage points in annual compound rate of return. I am aware that some money managers have exceeded this premium substantially for a 5-year period and some have exceeded it for a 10-year period, but most of these records have qualifying circumstances — usually involving a relatively small amount of capital under management by a few individuals during the early years. Any money management organization with a large amount of capital under management will find it difficult to reach that three percentage point premium over the S&P 500 for any time period in excess of 10 years. In my judgment, this result would be close to a Becker first percentile performance. I am sure that I would be turning clients away from my door in 10 years if I could attain only a two percentage point advantage.

Compare these hoped-for premium rates of return to current transaction costs in most institutional portfolios. Admittedly, it is difficult to measure transaction costs. Actual commissions paid are probably a minor fraction of the total.

Although I cannot prove this, I believe there are many money managers in today's world who produce transaction costs that reach, or exceed, 2% of those assets per year. A. G. Becker data for the past five years show a *median* turnover in institutional portfolios of 74%. One half of the funds did more! In many cases, current transaction costs are running somewhere close to the hoped-for 2% return premium above a passive portfolio. It is fascinating to realize that you could virtually double the premium return that active management is in existence to obtain — if you could eliminate the transaction costs.

What kind of results would good money managers produce without all that activity? The answer

lies in another question: Are we traders, or are we really investors? Most good money managers are probably investors deep down inside. But quotrons and news services, and computers that churn out daily investment results make them act like traders. They start with sound research that identifies attractive companies in promising industries on a longer-term time horizon. Then, they trade those stocks two or three times a year based on month-to-month news developments and rumors of all shapes and sizes.

THE HOW AND THE WHY OF BETTER PASSIVE PERFORMANCE

The notion that a "Coffee Can" portfolio can outperform an actively managed portfolio selected by the same investment management organization (at least over some particular time horizon) is not without a basis in logic. The basis is really simple. Take the example of constructing a new common stock portfolio of $100 million. The average, orthodox, professional money manager would build a portfolio of something like fifty $2 million commitments, each representing 2% of the fund. If that portfolio were then buried and forgotten for a while, several obvious conditions would apply. First, the most that could be lost in any one holding would be 2% of the fund. Second, the most that the portfolio could gain from any one holding would be unlimited. After all, there would be no one to apply the concepts of diversification and too much exposure to a given company, or a given industry.

The Coffee Can idea first occurred to me in the middle 1950s when I worked for a large, investment counsel organization, most of whose clients were individuals. We always told our clients that we were in the business of preserving capital, not creating capital. If you wanted to get a lot richer than you already were, then you should hire someone else. We were there to preserve, in real terms, the client's estate and the standard of living that it provided.

And, indeed, we were. The investment counsel business, as it is traditionally practiced, and probably as it should be practiced, is a simple process of making sure that clients never have so much risk exposure that their capital or standard of living can be impaired by some specific negative surprise. In other words, as your most successful investments grow in value, you make partial sales and transfer the capital involved to your less successful investments that have gotten cheaper. The process results in a stream of capital being transferred from the most dynamic companies, which usually appear somewhat overvalued, to the least dynamic companies, which usually appear somewhat undervalued.

The potential impact of this process was brought home to me dramatically as the result of an experience with one woman client. Her husband, a lawyer, handled her financial affairs and was our primary contact. I had worked with the client for about ten years, when her husband suddenly died. She inherited his estate and called us to say that she would be adding his securities to the portfolio under our management. When we received the list of assets, I was amused to find that he had secretly been piggybacking our recommendations for his wife's portfolio. Then, when I looked at the total value of the estate, I was also shocked. The husband had applied a small twist of his own to our advice: He paid no attention whatsoever to the sale recommendations. He simply put about $5,000 in every purchase recommendation. Then he would toss the certificate in his safe-deposit box and forget it.

Needless to say, he had an odd-looking portfolio. He owned a number of small holdings with values of less than $2,000. He had several large holdings with values in excess of $100,000. There was one jumbo holding worth over $800,000 that exceeded the total value of his wife's portfolio and came from a small commitment in a company called Haloid; this later turned out to be a zillion shares of Xerox.

THE TROUBLE IN MANAGEMENTLAND

Admittedly, there is a difference between the way we managed individual portfolios 20 or 25 years ago and the way that institutional funds are managed today. While today's methods are different, I am not at all sure that they are a whole lot better. We are still doing many of the same things today for institutions that we did for individuals years ago.

The primary difference is that we make our decisions on a much shorter time horizon. The old concept of averaging down has faded, to a fair degree, because that is hardly the way to get next month's market winners. On the other hand, most of us are faster than Wyatt Earp ever dreamed of being when it comes to taking a profit. The concept of being a long-term partner in a sound and growing business enterprise seems as far away as the Stone Age.

I believe there are two reasons why so many institutional clients are disppointed by their money managers, and why so many money managers are hired and fired every month. First, money managers have created expectations that far exceed their abilities. Second, they have encouraged the measurement of results on a short time horizon that is a far greater reflection of luck than skill.

The plain fact is that the professional money management fraternity of more than 2,000 firms has

produced a ho-hum aggregate result over the years. That is hardly surprising. We usually produce high turnover. Many money managers generate commissions each year that substantially exceed 1% of their assets under management. Thus, for example, firms that manage $1 billion produce $15-$20 million in commissions — a result that is totally incompatible with the word "investment."

The higher investment returns that should be the logical product of superior research analysis are dissipated in trading activity. That classic question, "Where are the customers' yachts?" is alive and well. We're making the brokers rich! That is one point on which the advocates of both passive and active portfolio management can agree. This problem occurs precisely because few money managers are willing to make a long-term decision.

INVESTING THE RIGHT WAY: INVEST!

As a money manager, I have frequently looked at an investment decision that I felt had a high probability of success on a three-year horizon, but about which I had many doubts on a six-month time horizon. Institutional investing, as it is structured today, simply makes it more difficult to make a high-conviction, long-term decision than to make a low-conviction, short-term decision. The rewards of short-term results substantially superior to the market, and the penalties of short-term results well below the market, are awesome. The only investment management organizations willing to take an extreme position are those with little to lose. Prudent investment management is really a sophisticated and complex system of hedging risks. The "go-for-it" philosophy may be a laudable personal approach, but it has no place in professional money management.

Nevertheless, the biggest earners in today's world are not rock musicians or professional athletes. Our system accords the highest earnings to money managers. I know perhaps a half a dozen people whose earned incomes exceed $2 million per year. All of them are money managers.

The rewards of establishing a successful, new investment management organization over the past five years have been mind-boggling. This success requires achieving something I would call "orbital velocity." You escape the force of gravity. Once you have achieved "orbital velocity," it doesn't matter what happens from then on.

To reach that exalted state, money managers have to produce an investment result that will get them in the top decile of the A.G. Becker universe on a three-year time horizon. Fortunately, it does not matter how much money is under management while this record is achieved. Then, a couple of skilled marketing guys will need about six months to raise between $500 million and $1 billion in new accounts. Because of the brilliant 3-year record, the money manager will ask for and receive a premium fee of perhaps .6% or more.

This is "orbital velocity." The firm has a revenue stream of between $3 million and $6 million per year, of which perhaps 70%-80% goes through to the bottomline, pre-tax. No matter how bad the performance may be in the future, at least four to five years will have to pass before they lose all those new clients. During that time, anywhere from $10 million to $30 million in revenues will cycle through the investment management firm, regardless of how they manage the clients' money. The firm's fixed costs are nominal. Even if the endeavor is a total flop, the principal or principals end up set for life.

Obviously, you don't achieve that top 10% of the A.G. Becker universe on a three-year time horizon without going out on the proverbial limb. A high R^2 is not going to do the job. The investment management organizations willing to take the required extreme positions are likely to be those with very little to lose. It is easy to see why turnover is up and speculation has replaced investment. Who wouldn't like to make two mil. a year?

Our business needs to encourage *investing*, both for our benefit and for the benefit of our clients. Though a bit gimmicky, the Coffee Can portfolio would serve this end. But I admit that I quake at the thought that someone will one day walk into my office and say, "Okay, Kirby, I read about your wild idea. I would like a Coffee Can portfolio for $100 million. What will you charge?" It's at that point that I have a concern about getting punched in the mouth. I really believe that if I were willing to accept the assignment for a $2 million fee, the client would be getting the bargain of the century. I am also fairly certain that if I quoted the price, I would get a split lip.

The Coffee Can portfolio concept has two problems. First, who is going to buy a product, the value of which will take 10 years to evaluate? A decade is likely to exceed the career horizons of most corporate executives and pension fund administrators, to say nothing of most money managers. Second, who will pay the large fee, up front, that is necessary to support a mature, first-class investment research organization needed to select a superior 10-year portfolio? You can hardly assemble a group of proven professionals for a one-shot project, no matter what the compensation. Further, even outstanding individuals do not constitute an effective management organization until they have had experience working together as a team.

In summary, I will restate that I am a firm believer in the process currently known as "active management." I also believe that the intensity and complexity of the measurement of investment results have produced a very short investment time horizon that actually diminishes the ability of money managers to make superior investment decisions. While I have criticized index funds based on the S&P 500 Index, my quarrel is not with those who believe that a passive portfolio will produce superior results. Quite the contrary: I believe turnover costs are a major detriment to total investment returns. The "run-sheep-run" style of investment management that is so widespread today may produce costs even more than the most zealous academic supporters of index funds suggest. We can make sound investment decisions on a five-year time horizon with greater certainty than on a six-month time horizon — and also save the investor substantial transaction costs.

I started this article complaining about the inadequacies of the S&P 500 as the basis for a passive investment program. I am ending it complaining that professional money management today is really sophisticated trading, rather than investment. We leave a major piece of total investment return on the table in the form of transaction costs. The second complaint is probably far more serious to large institutional investors than is the first.

The nice thing about the Coffee Can portfolio is that it solves both problems at the same time. It would be fun and interesting (and maybe very rewarding) to have someone come along and give the idea a try.