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INDIAN NATION, INDIAN TRIBE AND INVESTMENT POLICY

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MR. HOWARD H. KAYTON: The Investment Section's keynote speaker is Charles D. Ellis, Managing Partner of Greenwich Associates, an international business strategy consulting and research firm. He is the author of five books, entitled *The Classics, Investment Policy, The Second Crash, Institutional Investing*, and *The Repurchase of Common Stock.* Two of these have been translated into Japanese and one into German. He has also authored more than 50 articles on business, finance and investment management. He is a Chartered Financial Analyst and editor of *The Financial Analysts Journal.* He has served two terms as trustee of the Institute of Chartered Financial Analysts (ICFA) and one term as president.

Dr. Ellis earned a B.A. at Yale in Art History, an M.B.A. with distinction at Harvard Business School and a Ph.D. at NYU. He has taught the second-year course on investing at the Yale School of Management and at the Harvard Business School.

Before joining Greenwich Associates in 1972, he was Vice President of Donaldson Lufkin Jenrette, and an associate of Rockefeller Brothers Inc.

Dr. Ellis serves as a trustee of Phillips Exeter Academy and of Eagle Hill School. He is an overseer of the Schools of Business at NYU and serves on the visiting committee of the Harvard Business School. He is also a director of analysis and technology.

DR. CHARLES D. ELLIS: I would like to start by doing a little bit of research to see whether you are well qualified as an audience for the subject at hand. And I am going to ask you what I think is the most central question. If you think not about your fiduciary responsibilities, but rather for your own personal account, as investors, would you on the whole prefer to see the market up, or down? It is a simple and straightforward question, and it is a little deceptive as you would expect. It couldn't be so straightforward except if it were. I would like to invite you to a show of hands. How many, on the whole, just thinking in their personal accounts, would rather have the market really up there and roaring along? And who would take the other point of view, and would realistically prefer to see the market plummet and stay down for quite a while? Show of hands. I am astonished! This far and away is the largest vote in favor of decline that I have ever borne witness to; it shows the proficiency of your professional training.

Usually I get about 95% to vote in favor of a high market at which point of course the long-term rates return at their all-time low. Owning securities that are high in price is not a good thing. You should be selling them. The most wonderful thing the market can do for you as an individual investor, is to take securities down, down, down and hold them there while you save a little here and save a little there and buy some more of those absolutely cheap securities that sooner or later will drift on to their ultimate destiny of the same normal price that they would have had 20 years from now, 10 years from now, 25 years from now, as if you had bought them at outrageously high prices.

If you look back at your own personal experiences, the odds are that you have tended to be more favorably disposed toward purchasing securities when they are overpriced and more opposed or reluctant when they are underpriced. Even though you all know with your professional studies that in the long run, they are going to smooth their histories out toward some basic destiny, it

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can't be avoided. And one of the most wonderful things about investors in securities is they feelbest when the circumstances are worst and feel worst when the circumstances are best. Take that little idea, childish and foolish as it may be at some level, and profound and seminal as it may be at another level, and carry it with you wherever you go. That is the sum and substance of all that I have learned. You don't realize how long it took me to get there. I spent 30 years studying this marvelous subject, and after that 30 years, the substance of it was: Pogo had it right all along, "We have discovered the problem: it is us."

I am here to appeal with regard to a commitment to professionalism within the field of investing. And I intend to do it by describing two investment policies that may seem a little bit unusual and then presenting you with a truly heartrending story for which there was, at the time, no answer. In all of the studies that I have made of successful investment policy, by far the most successful is my own mother. She had a generally quite happy life, but there were some lumps along the road. One of the great lumps in her life was when she received a letter from her father who wrote longhand from Greenwood, Mississippi:

> Dear Eleanor:
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> You must plan now to come home at Christmas and stay. I can no longer send you anything to pay your tuition up there at Northwestern. I hope this won't cause you too much harm. It is wonderful that you have had a year and a little bit more of education, and I hope you feel well satisfied with that. I am sorry I can't keep going.
>
> Very truly yours,
>
> Father

Later on my mother was responsible for setting investment policy. My father's father died and left about $100,000. My mother put $25,000 in the bank for each of her four children.

She was subsequently asked, "Why in the world, in 1947, when everybody knew a bull market was coming, would you put the money in the bank? And if you had to put it in a bank, why didn't you put it in a savings account where at least you would get some interest?" She explained, "After I received my father's letter, many banks went bust. And all of the savings banks in the Commonwealth of Massachusetts have a provision where they can wait two weeks before paying you off if they want to. And my experience was that in less than two weeks even the nicest banks could disappear. And I had spent from 1932 to 1945 paying off the loans that I was able to get from my sorority at Northwestern. I paid the loans by typing for lawyers at seven cents a page and by making little girls' dresses with the puffed sleeves and smocking for $1 a piece. And I did finally pay off the loan, just a month before my husband came back from the Navy. I wanted to be sure my children would never have that experience." Twenty-five thousand dollars in cash was going to be enough, one way or another; they would get their education.

Anybody who wants to find fault with her investment concept and her investment policies has got some terrific studying to do. Because of course it was a brilliant solution to the obvious problem. Her kids were assured of an education. And who cares that she missed the bull market? Who cares that she didn't get the interest? She knew what she was doing, why she was doing it and she did it. Much to the distress of many observers she stayed with it and could not be changed until after we graduated. And then she didn't mind what we did with whatever might be left over.

The second investment policy that I think is particularly intriguing is Digital Equipment Corporation, a rather extraordinary organization, because of its rate of growth in employment and in sales and everything else. It has a very young work force. The average age of plan participants was under 30 when I last examined them. This remarkable company has a very highly paid work force and is very likely to have a substantial longevity in average employment.

It came to the rather startling conclusion that it was badly invested. I looked at its assets and thought it was conservatively invested because it had 50% in equities and 50% in bonds, and that is the way in which most corporate pension funds are organized. Someone came along and said, "No you are not. You have failed to understand your total portfolio; you are just looking at the part that is already present, but you are leaving out the part that is coming. You must include the part to come along with the present because you are managing a long-term investment. By the time frame that you should use for thinking about your investments, at least 20 years or probably

30, maybe even 40 years, you will have received huge amounts of additional contributions from the plan's sponsor. So where you look at your assets as 50% in equities, and 50% in fixed, reality is that you are 50% in equity present, 50% in fixed present, and that represents less than one-third of your total portfolio. You are actually 15% invested in equities, 15% invested in debt securities and the rest is in a long-term obligation by a plan sponsor to pay you at a fixed rate of assumed interest. You are badly mismatched because you should be almost exclusively in equities and you are almost exclusively out of equities."

Let me tell you my tearjerking story. Many moons ago, at least two, probably three and maybe even 4,000 years ago, the Penobscot Nation and the Passamaquoddy tribe found themselves in residence along the Penobscot and St. Croix rivers in Maine. It was a peaceful place until the Europeans arrived during the 17th century and stirred things up in disagreeable ways. The Indian people were able to see the right side of things and played a crucial role in the Revolutionary War on behalf of the Colonists. The result was that Congress took it upon itself to make a formal statement assuring the Indian Tribe and Nation that they would be "forever viewed as brothers and children under the protection and fatherly care of the United States." After the Revolution, this wonderful statement and promise fell into what can only be described as neglect.

In 1796, the Penobscots were pressured to give up 200,000 acres in exchange for some $30 or $40 worth of gunpowder and gunshot. In 1818, they ceded all the rest except 4 townships. In 1833, they sold the townships to the state of Maine for $50,000. Unfortunately the state of Maine did not manage those assets well, and they disappeared.

By the time we arrived in the mid-1960s, the situation was classic. There was 50% unemployment, alcoholism was chronic and the average income was one-third the average income of people living in the state of Maine, a state only slightly more prosperous than my favorite state of Mississippi.

Now there is a series of events that takes place. There is a late night poker game. There is a shoebox in which a treaty from 1794 is discovered up in the attic of an elderly Indian. Somebody wants to expand tourist cabins over in this direction and somebody else says the treaty prohibits the expansion the treaty says it belongs to the Penobscots. There were some strong arguments, it became high level politics, and the Indians staked out a claim. The claim was not small. They claimed two-thirds of the state of Maine. They also claimed that they were entitled to receive a total of $25 billion for trespass damages by the 250,000 people who had been walking around their land.

With that negotiating start, they engaged in what turned out to be five years of legal proceedings. It drifted on up through state courts at which point one of the state jurists said, on appeal, that it seemed to him that there was a reasonable case on behalf of the Indians. That caused Ropes and Gray, one of Boston's great law firms, to say they couldn't give a clean opinion on the state's municipal securities offering, and $300 million of municipals got held up. The people in the state of Maine didn't feel that they were getting the roads constructed the way they needed them and it became a political issue. The problem moved up to the federal level and President Jimmy Carter asked one of the former associate Justices of the Georgia Court to find a resolution. One was found after three years. First, $54 million worth of land would be purchased in Maine on behalf of the Indians and turned over to them. Second is that $27 million in cash would be released from the Department of Indian Affairs as soon as the Indians were able to present sensible investment programs whereby they would invest that money.

An advisory committee of experienced investors was to be formed to help the Indians develop a sound plan. Any right-thinking American citizen would have been thrilled when asked to volunteer to do something on behalf of the classically mistreated Indian people. They clearly needed the professional competence that sits around the tables here; it couldn't have been an easier thing to sign up for. I got the call. I was thrilled by the comembers, one of whom was the chief investment strategist of one of the nations' most admired securities firms; another was the President of one of the largest mutual insurance companies. This marvelous group of sensible, caring, widely uninformed individuals representing the Nation and the Tribe, had come all the way to New York, for the first time in most cases, with the hope that they would be able to get some real help from experts. My two comembers, it developed, were unable to attend. They sent substitutes. The expert advice was fabulous -- and awful.

One of the fellows tried to explain how they might want to invest in gold -- as a defensive measure. Perhaps other commodities would be more interesting and they could change their portfolio over time as they saw commodities rising and falling in relative price and relative value. Another fellow tried to explain some of the intricacies of real estate investing and suggested that a diversification of the portfolio over geographic territory might be helpful. It was not necessary to do international real estate investing, but it might be something to be considered. Some of the others were talking about equities, some were talking about debts. One of the fellows had an interesting way of looking at a combination of options with Treasury securities.

As I listened to this dispersal of information and possibilities, it occurred to me that we were missing one of the great chances of a lifetime to do some good, and we were about to do some real harm. It never occurred to my comembers to try to help the Indians define what the issues really were.

Think for a minute. Who are the beneficiaries? You have the Tribe and the Nation, they have been alive for some 3,000 to 4000 years. Along comes the U.S. and says, "Today is the day, here is your $27 million." Should the people who are living at that time, just go ahead and spend it, or should it be reserved? If it is reserved, should it be used for providing retirement benefits to the old, or educational scholarships to the young? How would you make the determination and if you started making a determination within a Tribe or Nation, how do you keep wisdom safe from politics? What is income? Is it before or after inflation? Is it adjusted for the size of the population? Do you want to adjust it for economic wealth or failure within the community? What is the time frame within which you would make your investment decisions? How would you evaluate and select the managers? What is performance? What is a realistic set of expectations? What is unrealistic and how can you govern your own realistic and unrealistic characteristics? How would you make the determination? And, if you started making the determinations within a Tribe or Nation, how do you keep wisdom safe from politics?

It was a wonderful opportunity but it was never really discussed and certainly never considered. And it was at that time that I got really interested in the possibility of trying to pull together what we know in general about investing. And I have a few conclusions that I would like to offer.

First is it is obviously most important to be in the right place at the right time. Those Indians who received the money are a lot better off than those Indians who lost their prior lands. Let's look at some of the things that might make a difference from an investment professional's point of view. There is a great paradox that haunts investing and investment management and that is they spend almost all of their time and energy and skill working at something that is very hard, markedly unlikely to be successful, and if successful, will pay small rewards. They spend almost none of their time working on anything that is remarkably easy or even pleasant, that's almost assured of being successful, and where the rewards are relatively quite large.

The task to which most of the time and energy is devoted is obvious. That is this unrelenting determined effort to beat the market. Find some way to get a higher rate of return than other equity or debt portfolios. And it is a fabulous process to watch. Some of the most talented and able individuals in our society work unbelievable hours striving to get somehow ahead of one another.

Of course, on average, they haven't a chance, because they are competing with one another. They are not competing with some separate phenomenon, "the market." Every time I buy, I buy from you. Every time I sell, I sell to you. The only way in which I can do better is if you do worse. If you are a professional and you are full-time, and you are deeply engaged in this business, which represent 80% of the securities transactions that take place in the course of the day represent, there is very little chance that I am systematically wiser, or smarter, or earlier, or faster, or stronger than you are. There is certainly very little chance that you would let it stay that way if I were for a while somehow smarter or stronger. If you would stay incompetent, you would be displaced in this marvelous free market by those who are not incompetent. I will face the best investment talent on the other side of every transaction and my only way of being successful is to find others making large enough, regular enough errors that I can live off their mistakes.

That is a very modest expectation. If you would come with me and tour the investment managers of the nation, let alone the managers who represent themselves in this market and live in other

nations, I think you would share with me the feeling that some terrific talent is involved there. I wouldn't want to take them on. I can't imagine doing it for a lifetime.

There is another undertaking that is remarkably easy work, capable of generating extremely substantial rewards, and highly assured, given a reasonable amount of time. And that is the gentle process of establishing sensible, long-term investment objectives, and determining sensible long-term investment policies that will, given time, achieve those objectives in a realistic manner and holding on to them. Benign neglect has got a great role to play in investment management. Almost no one does it and I would like to understand why.

First I understand that it is not any fun, it is not interesting and it is not exciting. Plan vanilla works in setting investment policies. Second it leaves you out of the flow and the excitement. You are not going to be invited to really interesting experiences if you think that beating the market is a waste of time. What you want to do is be in the right places over the long term and not change very much. That is certainly part of it but there must be something else involved that would attract human talent in such large numbers to something that works so badly. The problem is not that the managers are bad managers, it is that they are so good, terribly good.

I have captured it for myself by describing in comparison the game of tennis. I make a large number of mistakes. I am impressed with how easy it is for me to double-fault and how high the net sometimes is and how short the backcourt sometimes is. But when I watch Ivan Lendl and some of the others who play, I have come to realize there are two widely different games being played. Their game and my game are superficially quite similar because we wear the same clothes, we play on the same surface and court and we keep score in the same announced way. But in the game that they play, they force errors, they win points. In the game I play, we make errors and we lose lots of points. In the game I play, the understanding for those who would like to win is simple: let the other fellow make mistakes. The easiest way in the world to win a game of tennis is just by hitting it back hitting it back, until the other poor guy finally goofs. That is simple and easy to understand.

A losers' game is the game where the ultimate outcome is determined by the actions of the loser. A winner's game is a game in which the outcome is determined by the winner. Tennis by the professionals is a winner's game because only the winner is determining the final outcome. And in the game I play the one who can lose fastest determines the outcome of the game. It's a loser's game.

Similarly in investment management the outcome of the game is determined by those who lose more than the others. The great curiosity is that most people who are involved in playing the investment game think that it is a winner's game.

In the process of investment management some wonderfully gifted and able people are hurting their results. The dreadful curiosity is that their clients encourage them on, instead of saying, "Wait, this isn't a game, this is real money. The small differences of error and mismatch that you have are not the real problem. The real problem is that by concentrating on trying to beat the market, you are too intensely involved with it, and you are committing profound errors at the same time that you are trying to make small successes."

My belief that those who will be upset and distressed by their managers have made a mistake. It is not the manager's fault, it is the client's fault. Those of you who are interested in applying actuarial science to investments should help the client understand that the really important work of investment can only be done by the client, truly with the shared help of the investment manager. But the really important work is setting long-term objectives that are right for the particular client and are realistic within the market. That is the productive part of the work. That is what is really worth doing.

Consider the difference between short run and long run. If you think in terms of short run, the safest investment for certain, is a Treasury Bill. You get your money back after inflation plus a little something. And in the short run that is clearly the safest solution. In the long run it isn't safe at all because all you do is get your money back. In the long run the safest investment has always been and always will be equities but in the short run it is certainly the most dangerous.

In investing, time is Archimedes lever because it changes everything from being most dangerous to being most safe, and from most safe to most dangerous. If you take the twenty or thirty year horizon, it leads profoundly in directions different than if you take the twenty or thirty day horizon that most investment managers can't help but take.

Here are a couple of thoughts that I would like to leave with you. One is to have a written policy. The purpose of a written policy is to protect the long-term purpose from the short-term activity. Ad hoc decisions, particularly made by boards of directors under great pressures, with powerful minds or powerful people, tend to make errors. Time-urgent decisions are never fiduciary, and they are almost always wrong. The reason for having a written policy is to protect our portfolios from ourselves.

The true test of a policy is not that it can be written up. If you don't have a policy statement for investing that a competent stranger could take out of an envelope, never having met with you or discussed it with you, and implement in a sensible way for five or ten years without interference from you, then you don't have an investment policy. If you do have a marvelous opportunity to be doing the things that really matter.

The client's first responsibility is to understand their true investment objectives and interest and their anxieties. Second, be sure that they study as much as they can about investing in investments to reduce their anxiety level as much as possible. The opportunity cost of being an anxious individual is spectacular. The cost of doing a modest study of investments and becoming comfortable with the curious realities of that field is very modest, and there is some charm in it. First, understand yourself. Second, understand the markets, and understand them well enough so you don't overreact. Third, take the discipline of working out and holding onto a sound set of long-term investment policies. And finally, hold to them so that you can protect yourself from the disconcerting interim.