Is Your Bank A Closet Indexer?

When I look at the all equity trust portfolio 'actively' managed on my wife's behalf by the Mellon Bank, I can't help but wonder why there are so many different stocks. It's a large account to be sure—about 15M—and no one is suggesting that some diversification is not a prudent thing. But 63 individual holdings plus two stock funds spread over twenty-six different economic sectors seems like overkill. With an average stock position of about $190,000 (not counting the funds), how is the portfolio ever going to score big time? Of course, the answer is never. With the assets allocated in drips and drabs across virtually the entire economy, it's a safe bet that it probably won't ever under-perform the S&P but hasn't a prayer of beating the market by more than a few percentage points—and it may not even do that every year. Is such incremental performance worth the extra cost of active over index management? For smaller trusts forced to pay 1.5%+ in management fees plus costs, it's certainly questionable. But with bank managed common trust funds (CTF's) increasingly being converted into proprietary mutual funds jumping existing administrative costs by 50-100 basis points (less any partial and possibly temporary discounts), active management will likely become prohibitively expensive for the smaller account. Thankfully, these new costs are taken quietly from principal rather than income. So individuals trying to make do on the income from an equity portfolio currently yielding an average 1.1% won't be squeezed any further. It just means sharing more of any future capital gains with the bank!

If the account is of sufficient size to warrant active management, I believe it is cost effective to focus one's investment resources on as few situations as possible consistent with one's risk tolerance. In fact, I argue that maximizing returns means *limiting* diversification—i.e. placing your bets on a smaller number of situations where you have both better information and the promise of superior capital gains.[1] Obviously, that can mean emphasizing the smaller, growth oriented company rather than the big caps.[2] To be sure, watching a portfolio of smaller growth stocks requires more time and energy and may increase the trustee's exposure to a surcharge action should a particular investment not work out. So your bank will not be pleased with such a suggestion. And why should the bank's trust department stick its neck out when it can meet its fiducial obligation simply by staying close to the S&P? Consider the following. Six leading trust experts including Yale guru John Langbein met in 1998 and concluded that all a trustee needs to do to meet state prudent investor guidelines is deliver *average* (read S&P) performance and, in fact, need not even seek—<u>seek</u>, not <u>get</u> mind you—the best rate of (total) return! So any settlor convinced that the bank is going to grow his/her legacy into a family dynasty may be surprised to learn that he and the bank may not be on the same page.

---

[1] That is not to say you should head for one of the so-called 'big bet' funds that limit their holdings to fewer than 35 stocks. In a recent Morningstar survey, such funds didn't do as well as the S & P 500 over the last five years! From *Big Bet Investing*, <u>Time</u>, September 14, 1998, p. 83.

[2] Joan E. Lappin, a top money manger for Gramercy Capital Management, agrees. Even with 200 million to invest, she argues that 10 stocks is plenty. In her words, "even if one totally blows up, your total exposure is only 10%." In fact her personal account holds only four stocks. See James A. White, "For This Top Money Manager, A Handful of Stocks is Enough", *The Wall Street Journal*, (December 19, 1991), p. C1.

It's a reasonable premise that 'small' companies can grow faster than 'big' companies. That's just because it's (arguably) a lot easier for Uncle George's Widgets (UGW) to double its annual revenues than a company the size of a GE-despite any cost efficiencies of the big caps derived through mergers, etc.. No surprise then that the 'small caps' (fifth quintile NYSE issues) have outperformed the 'big caps' (S&P 500) by 4% over the past five years ending December 31, 1996 and by about 4.25% over the past 20 to 70 years ending 1996.[3] So why buy a big cap stock? One reason is that the prices of big caps are presumably less volatile (less risky, some would say) so owning them is certainly more comfortable than having a major position in UGW. In fact, even if UGW could be expected to triple in less than six months, there is more than a finite possibility that it might also go south, an unlikely event for a GE or even a GM. So as investors, we sometimes deliberately sacrifice total return by investing in companies promising steady if less spectacular growth, especially where a reasonable dividend is available.

Of course, we all know that the conventional way for damping out price volatility is by diversification— owning a *portfolio* of issues rather than concentrating all one's eggs in one basket. The advantage is that now one can believe that he/she need only worry about how the *portfolio* performs rather than its component issues. But like prescription drugs, less diversification can be better than more. Here's what I mean. Suppose you own one stock with a one in two chance of doubling but the same chance of tanking. To reduce the chances for loss, you *diversify* say by buying two stocks, each in different market sectors if you wish but (say) with identical odds. Now you have reduced the chance of a wipe out from ½ to ¼ i.e. chance of a wipeout with stock A = ½ times the chance of a total wipeout with stock B also ½ = ¼. But the same arithmetic also shows that we reduce the chance of doubling the value of our 'portfolio' to ¼. No free lunch here. Interestingly, what also happens is that the chances of getting average performance (which in our contrived example means no change in the value of our 'portfolio') goes way up—to ½. Unfortunately, this phenomenon, known to statisticians as the 'regression to the mean,' gets us the more we diversify. In short, the greater the number of issues we hold, the greater the chance that our portfolio will perform just like the S&P! It's not that average - read index - performance is a bad objective—its just that we should expect more performance bang for our buck if paying for active management. Fortunately, including a few big caps can buy you more diversification than you think. That's because the product/service mix of many of the big caps is already so well diversified. But where diversification shines is with the volatile small caps with strung out price-earnings ratios. Here it doesn't matter (at least ultimately) whether UGW fails to deliver if there are other promising issues with exceptional risk-reward ratios in your portfolio.

Here's what you can do to boost your total return. If you must own 50 companies, why divide your assets equally? In real life, the growth prospects of companies differ. So if we diversify uncritically, we wind up 'wasting information'—i.e. we fail to get our bets down on those issues where we have better information and/or prospects and we therefore fail to get the maximum bang for our investment buck. So to maximize total return, broad, uncritical diversification is not the play. Unlike Mr. Buffet, the resources of

[3] *Ibbotson Associates, Stocks, Bonds, Bills and Inflation; 1997 Yearbook, Market Results for 1926-1996,* (Chicago, IL: Ibbotson Associates, 1992.) Write them at 225 N. Michigan Ave., Ste 700, Chicago, IL, 60601-7676. Ph. (312)616-1620.

your bank or you as an individual investor may be limited. So I believe it's better to place fewer bets and follow those *intensely*.

There is a downside to this thesis. Even an assemblage of growth stocks will fluctuate more in price than a well diversified big cap portfolio. But if one is willing to sacrifice some total return in order to reduce price volatility, go for the latter. But remember that capital gains sacrificed on the alter of diversification cannot accrue to *add* to next year's earnings base and so forth. That is, investing for growth can produce *exponential* gains in total returns; investing to minimize risk will not. Of course, someone with a billion dollars may be quite satisfied with the rock solid 6% nominal return of a portfolio of Treasury bills. But the smaller or younger investor or even his/her parents for whom the marginal utility of a dollar is still finite cannot afford *not* to invest aggressively. For example, a stock that offers an above market payout such as a utility is not likely to offer the *total* return available from the up and coming company which, by the by, needs *its* cash to finance its own growth. (In fact, it's oft said that investors *demand* a high payout (and thereby sacrifice some total return) when buying utilities precisely because their prospects for growth are often so minimal.) Indeed, the small company with plenty of room to grow—or even the more mature company in a long term high growth sector—has yet another advantage in that it can be held longer, thus reducing transaction costs while delaying the realization of capital gains. That also helps maximize future returns!

Now what about your bank managed trust portfolio—in particular, the equity side? Is it loaded with big caps with recognizable names as is my wife's portfolio? And how are they performing vis-a-vis the S&P 500? I had occasion to discuss the issue with her investment officer at the Mellon Bank. Here is what I learned. Mellon, like most big banks, runs a 'master list' of stocks which have been prescreened on a number of variables such as price earnings ratio, earnings record, volatility, etc. The account executive uses this list to design an individual (equity) portfolio which is consistent with the clients objectives (growth, income, or a mix of both) and with Mellon's objectives as well (minimum volatility, etc.) The investment strategy employed by Mellon is tied to the entire economy and, by default, to its proxy, the S&P 500 index. As you surely know, the S&P is composed of 500 stocks broken into ten sectors from 'energy related' and 'health care' to 'metals and mining.' (The total market value of the securities in each sector determines the weight of that sector in calculating the index itself.) In assembling a diversified portfolio, Mellon (reportedly) aims for the same sector weighting as the S&P index while striving to chose the best individual equities within each sector with the restriction that no single equity can make up more than 10% of the portfolio. It's hard to fault this so-called 'sector neutral'[4] approach so far as it goes. But one could raise the question as to why virtually every sector of the economy need be represented if to do so means including some less interesting prospects just because a particular sector would otherwise be underrepresented. For example, why bother with steady but dull Uranium Associated Shareholders Syndicate—ticker symbol URASS—if an industry hi-tech leader such as Park Electrochemical can currently be bought on the cheap? Put otherwise, granting that analysts in mining/metals vs. hi-tech might find it difficult to compare

[4] For more information, see Mary Connors, "Tracking An Index, With Room To Wiggle", *The New York Times*, (October 11, 1998), p. 38 (BU)

notes, why ignore a good stock just because its not in the 'right sector' and then rationalize the decision on the alter of greater diversification? Is the objective to construct a portfolio with maximal prospects for total return or merely one that mimics the S&P? More specifically, should not the a) investment prospects and b) quality of information determine the *capital allocated to each sector* as well as the specific stocks included in that sector. Or does Mellon simply construct a portfolio of stocks of greater and lesser promise simply in the interests of broader diversification? I don't have the answer and Mellon isn't talking except to say I can have any changes I want so long as it doesn't affect Mellon's 'investment strategy.' But I suspect that diversification is emphasized. If it were not so, stocks of the future—the biotechs, computer related and financials not to mention overseas opportunities would be much better represented. And because growth, not yield is key, one might conclude that a portfolio constructed with such emphasis on diversification incurs significant opportunity costs.

Another sore point with Mellon is the small value of positions taken in some issues. A weak position might make sense if it offered a very exceptional risk vs. reward ratio. In this case, Mellon currently holds 400 shares of Dupont (currently worth about $24,000) and 500 shares of Chevron (at about $45,000). Since neither Dupont or Chevron is likely to be the next Yahoo, is the time and effort expended to monitor these two companies worthwhile when the assets invested therein could just as well be allocated elsewhere? More significant is the size of the companies making up the portfolio. With virtually no exceptions, all are household names (GE, Monsanto, Bristol Myers, Coca Cola, etc.) which one must presume are intensely followed by the analysts and hence not as likely to be 'under valued' as their less scrutinized small cap brethren. Unfortunately, visible companies with consistent, generous dividend records (relative to low caps) and steadier prices can and do command higher premiums than the latter and therefore promise diminished total returns.

Perhaps banks have other reasons for preferring the 'big caps' in managed trust accounts. One possibility is that a company gone south exposes the trustee to a downstream surcharge action if not from the income beneficiaries then from the remainder interests who, unlike the income beneficiaries, may not have to worry that their legacy will be tapped for the bank's defense costs. And why, indeed, should a trust institution raise the eyebrows of the banking auditors simply to make a killing on UGW when the legal consequences of failure don't balance the prospective reward *to the trustee*? Then there is the need for liquidity. Transactions of any scale in small caps might be subject to delay and adverse price movements.

Those of us burdened with bank managed big cap portfolios can at least take some solace in the fact that they sometimes do perform quite well relative to the small caps for a multiple of reasons including the indexing boom, foreign investors preference for big household names, and a possible oversupply of IPO's over the past three years.[5] It would seem that institutions are forced to compete against each other in the big cap markets where they represent at least 50% of the action. Sound like a ponzie scheme?

The Mellon Bank admits that it often is described as a closet indexer. I think there is a grain of truth in the assertion. What about your bank?

[5] Remarks based on an article by Linda Sterm, "Big Hopes for Small Stocks", *Newsweek*, (August 10, 1998.)