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Advancing the State of the Investment Art

The Value of an Academic Approach

Academic research has made profound contributions to our understanding of financial markets and securities. It has also provided many of the tools central to our practice of institutional investment management. The economic power of large institutional investors has attracted the notice of a generation of smart academics and practitioners, who have spent uncounted hours addressing their investment challenges. Some solutions are elegant, and some just pragmatic, but the ones that have persisted are generally effective. This accumulated academic and practical knowledge has regularized the management of institutional portfolios so much that we can usefully regard institutions as a homogeneous class of investors.

In the years since I made the professional leap from investing for institutions to serving individuals, I've often noted how sketchy and imprecise the application of academic research is on the individual side. As successful as academic ideas have been among institutional investors, their influence is less pervasive among individuals and the investment organizations that serve them. Yet while the specific investment issues that I constantly face with individuals are more interesting and challenging than with institutions, and I have developed a number of successful strategies for tackling them, I often find the relevant academic research limited. The reason for this gap in the focus of the academics may lie with two advantages institutions have over individuals — safety in numbers, and tax-exempt status.

Safety in numbers among institutional investors takes various forms. The sheer number of dollars in their portfolios makes providing diversification easier. Professionals managing institutional portfolios also have the luxury of regarding their performance as satisfactory so long as it isn't much worse than what's normal among their peers. The effect of terrific or awful investment returns flow through to the actual activities of most institutional investors only slowly.

Institutional decision-makers themselves rely on safety in numbers, too. Pension boards, investment committees, consultants, and money managers populate a vast group decision-making structure that insulates individual decision-makers from the harshest potential consequences of their choices. If the same people individually make disastrous decisions in their own portfolios, the effects on them personally can be far more severe. In my career in institutional investment management, I often made presentations to pension boards. These groups varied in composition, but I found many of the public pension boards, like that of the New Mexico Public Employees' Retirement Association in Santa Fe, to comprise intelligent laypeople, who took their responsibility seriously. They relied heavily on both their pooled common sense and the advice of experts to keep their investment decisions on track.

The deliberative, large-group decision structure that most institutions use to manage their investments provides a natural place for academic input. Academic research and institutional decision-making both proceed in an evolutionary fashion, with substantial checking and re-checking, consensus-building (some call it herd behavior, especially when the consensus turns out to be wrong), and long feedback cycles. Over the course of about a generation, the two processes have worked well together, as institutional investors have posed their challenging questions, academic researchers have worked through them in detail, and the results have expressed themselves in investment decisions that have generally worked well.

Individual investors enjoy neither the advantage of "safety in numbers" nor a tax exemption. Unlike institutions, individuals and families aren't homogeneous at all. Every investor's situation is unique. The consequences of poor investment decisions are more serious for individuals, too. For many, a bad enough year can result in substantial changes in how they actually live. Personal circumstances, the need to provide for emergencies, and taxation each add a layer of complexity to individual investment decisions absent in the institutional environment. The same intelligent laypeople that can rely on their common sense and expert advice in managing large public pension funds need investment advice that can play out equally well in their personal portfolios. Only recently, however, has academic research begun to address systematically the range of questions facing individual investors — questions more complex, more diffuse, and more urgent than those facing institutions.

Good News from Academia

As many of you know, while at Yale for my Ph.D. in finance, I was fortunate to study under, and have as my dissertation advisor, Stephen A. Ross. Professor Ross, now the Franco Modigliani Professor of Financial Economics at the Sloan School of Management at MIT, was then and is still a highly respected academician. His work includes the development of the Arbitrage Pricing Theory, and he is the author of the still current textbook *Financial Management*. Professor Ross taught more than just accumulated academic knowledge. He taught his students a methodology for thinking about financial and economic issues, which I have always believed was the greatest tool that I brought with me from graduate school to my career in investment management.

In mid-October I had the pleasure of joining nearly 50 fellow Ph.Ds at a conference in Steve's honor. Every participant had earned a Ph.D. under Steve's tutelage, either at Penn, where he first taught, Yale, or most recently MIT. These former students now include finance professors from leading universities, successful practitioners from a number of segments of the finance industry, and quite a few whose activities straddle academia and business. Plato would have recognized the weekend as a modern evolution of the classical Symposium. It was part academic conference, part reunion, and part a celebration of Steve, full of humorous testimonials, gifts, good food, and wine.

The centerpiece of the conference was a day of academic presentations and panels, with plenty of time for informal conversation. What a pleasure it was to be able to hear from Prof. Torben Andersen of Northwestern University about his most recent research trying to understand the performance of option-market implied volatilities as forecasts of actual market volatility during the life of those options. Or to talk casually with Peter Niculescu of Fannie Mae about the subprime mortgage mess, or with Larry Weiss, formerly of Goldman Sachs but now a private investor, about dislocations in the interbank lending market over the previous couple of months. The Steve Ross conference was more than an opportunity to fete Steve, see old friends, and take part in a gathering of distinguished company. It also gave me a chance to hear about a bit of current academic research, talk with leading researchers and finance practitioners about their work, and reflect on how my own efforts in investment management have remained true to my academic background and reflect accurately the current state of the art in individual investment finance, both academic and practical.

What I learned reinforced my sense, already strong, that my identification of issues, my quantitative approach and my professional philosophy are on the leading edge of efforts to strengthen qualitatively both the understanding and the practice of investment management for individuals and families.[1]

Academics and Individual Investors

As I've noted, academic research to date has offered only limited help to individual investors. That is finally beginning to change, but slowly. At the Steve Ross conference, Prof. Larry Kotlikoff of Boston University mentioned an effort he has undertaken to model and to systematize certain retirement choices. So far, though, he has found the problem too complex, largely because of tax and benefit rules, to allow complete solutions. I also spoke with Prof.

[1] Most academic discussions of the economic behavior of individuals and families refer to them as households. The term has the strong virtues of simplicity and accuracy, but in my mind it has taken on a connotation of being an economist's abstraction. I choose the terms "individuals" and "families" as a reminder that the household economic choices that matter most to me have direct consequences in the lives of people I know. For convenience here, I'll just use the term "individuals."

Chester Spatt of Carnegie-Mellon, who has also spent time at the SEC, about work he has done on the asset location problem, the question of which assets an individual ought to place in taxable accounts, and which in tax-deferred accounts. It has been gratifying to realize that Prof. Spatt's conclusions generally agree with the approach I have taken, but his work hints at the further benefits of careful, academic study. A thoughtful model can illuminate the limits or exceptions to what otherwise would just be a useful rule of thumb.

We're also learning more about what individual investors actually do. Prof. John Campbell of Harvard described his work with a large database of individual portfolio holdings, which he has examined just to figure out how individuals really invest. In broad strokes, he has discovered that some investors hold excessively concentrated portfolios, taking too much risk without enough compensation in terms of potential reward. Others, however, perhaps lacking confidence, take too little risk, sacrificing opportunities that ought to be within their reach. Prof. Campbell has also published research on how investors' choices should vary through time. The mathematical machinery for this work is still only partially complete, but it begins to connect the relatively straightforward institutional world, which we've mostly mastered, to the more complex reality of individual investors.

We don't know exactly why individual investors make the choices they do, but Prof. Will Goetzmann of Yale reported on survey research he has conducted to try to find out when investors are more likely to think that stocks are under-valued, and when they might think they are over-valued. Part of the motivation for this work is to understand patterns of behavior, but understanding patterns of investor thought may also help us give investors better advice.

The State of the Art, in Practice

If academic research focusing on the questions facing individual investors is still in its early stages, the industry that looks to manage individuals' portfolios is not. In this connection it was interesting to compare notes with Kate Warne of Edward Jones on the challenges she and her colleagues face in matching individuals and investments. Just think about the bewildering array of investment products from which an individual investor has to choose — mutual funds, separate accounts, mutual fund wrap programs, separate account wrap programs, funds-of-funds, managers-of-managers. It's a wild and haphazard canvas, revealing a bizarre *pentimento* from successive generations of products aimed at gathering assets and focused on the business success of the providers and brokers, rather than the investment success of individuals.

My conversations highlighted to me the problems, which I've identified in prior notes, that arise from a focus on selling investment "products." Too much of what passes for innovation in the traditional industry serving individual investors focuses on creating products, distributing them, and giving financial intermediaries new, or more saleable, ways of hunting through a growing menu for bits of portfolios that would at least be reasonable.

In my own work on individual investing, I have built on what I learned in graduate school from Steve Ross. Faced with a conceptually difficult problem, we try to go back to first principles. We abstract the problem, drawing out the nuggets that represent the essence of the issue, so that the problem becomes more tractable. We then work on the abstracted version of the problem. Once we have a working solution, we go back and judge whether it will suit not just the abstracted version of the problem, but the real one. I've tried to follow this procedure in thinking about how to build portfolios for individuals and families. The result isn't a product, but rather a methodology.

I've written and talked elsewhere about my methodology for managing individual portfolios. In brief, my goal is to use sound principles to design and manage sound portfolios directly, rather than by selecting products. After all, if every individual investor is unique, then each portfolio must be distinct as well. Delivering such a high degree of customization requires a robust process, which accepts inputs describing a broad range of investor circumstances. The greater the depth of our theoretical knowledge of the challenges facing individual investors becomes, the more completely the process can capture individual needs.

A Look Ahead

The Steve Ross conference gave me a good sense that we're making progress in the area of individual investing, but just as in every worthwhile pursuit, the opportunity to push further never ends. So if I may, let me say to my academic colleagues: I'm loving your work so far, and I can't wait to see more. The questions facing individual investors more than meet the criteria for good research questions — they are interesting, difficult, and important. A generation ago, academic researchers cracked a series of important problems that had vexed institutional investors. I'm cheering for progress in helping individuals. If I can provide insight or help you identify which questions really matter to individual investors, please pick up the phone. You know that I like talking with you anyway.

To my industry colleagues: You're spending too much energy concentrating on products, distribution, and sales. Those are important matters, for without them you can't accumulate the small, tactical victories you need to succeed. But they aren't enough. Remember that in any business, long-term dominance belongs to those that best understand and meet the needs of their customers. So help the academic researchers, who are trying to understand individual investors, and pay attention to what they have to say. Then concentrate on methods, not products.

To individual investors: We have made tremendous progress in thinking about your investment challenges, and we can serve you far better now than we could even five years ago. But the improvement is an ongoing evolution. So please put yourselves into the process. See who is thinking deeply about individuals' investment problems. Who is trying to understand how one investor differs from another, and how their portfolios should differ? Who is trying to find effective ways to manage portfolios, rather than just build hot products and effective sales techniques? Keep telling us what's most important to you. Keep raising ideas. And most of all, keep asking the hard questions, because we'll never really get it right unless we can include in the process the kind of collective common sense that animates the best public pension boards.

Conclusion

Classical literature suggests that the ancient Greeks understood how to learn, and how to advance knowledge. They understood that the exchange of knowledge and ideas is often most fruitful in a convivial setting. They realized that conviviality can take the edge from what might otherwise be bitter disagreement, allowing parties with differing views to talk and listen longer and more productively. They can part friends, each richer for the productive disagreement. And so emerged the Symposium. Attending a meeting like the Steve Ross conference, which combined such depth of discussion and enjoyment of social interaction is a rare treat.

I learned a number of things at the Ross conference. Most important, it provided me a helpful perspective on the current progress in academic research, particularly as it relates to individual investors. A number of distinguished scholars put forth exceptional effort to make the event happen. I particularly thank Prof. Anat Admati of Stanford, Prof. Jonathan Berk of UC Berkeley, Prof. Doug Diamond of the University of Chicago, Prof. Mark Grinblatt of UCLA, and of course, Professor Ross himself, for a terrific event.

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