



Our Interview with Charley Ellis

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Charles D. "Charley" Ellis is a consultant to large institutional investors and governments. For thirty years he was managing partner of Greenwich Associates, an international business strategy consulting firm he founded that serves virtually all the leading financial service organizations around the world. Mr. Ellis earned his BA at Yale and his M.B.A. (with distinction) from Harvard and his Ph.D. from New York University. He has taught investment management courses at Harvard and Yale, is the author of 14 books, mostly on investing, and has written nearly 100 articles for business and professional magazines.



He currently serves on the investment committees of Yale University and the Robert Wood Johnson Foundation, chairs the Whitehead Institute and is a director of Vanguard.

We interviewed Mr. Ellis on May 9, 2008.

One of the fundamental concepts you advocate is that asset allocation is the area where advisors can add the most value, both at the asset class level and within equities (by style box). Given your 30+ years of experience in the investment industry, how have your views on this issue evolved over time?

Adding value through asset allocation at the asset class level is much more important. My views on this have become clearer and stronger over time. I have not found anyone who has come to a different conclusion. Picking stocks looks easy. It can be exciting and, as human beings, we all believe we can do this. Only after many failures do we discover how really hard it is. Many truly brilliant people are competing with active investors. The strongest minds I know are among those in the business of actively managing money, and I believe that, in the long run, they will dominate the competition for finding alpha.

Occasionally, such as at the end of the millennium, some crazy thinking can permeate the markets and create inefficiencies. But most of the time the markets, and the thinking of these brilliant people, get it right – meaning that securities are fairly valued.



Given that asset allocation is a critical, if not the most critical, determinant of investment performance, what specific steps do you recommend for advisors (those serving HNW and UHNW clients) when determining asset allocations for clients?

The common adage in business is to “know your customer.” But for advisors, I modify this to “know your client.” A customer is someone with whom you have a short term transactional relationship. Clients are served for a long time. The relationship is very different. Advisors have a long term commitment to their clients. The key for advisors is to subordinate their own interests to those of their clients, and to focus on really caring for them. This advice manifests itself in two ways.

First, there is no single asset allocation that is right for everyone. Asset allocation can be made truly appropriate only at an individual client level, based on their emotional makeup. Advisors need to understand their clients’ strengths and weaknesses, not just their financial circumstances. It is clients’ emotions and lack of experience that get them into trouble. That’s why they want advisors they can trust.

Second, advisors need to ask what their clients are capable of living with and living through. What do they really know about their own situation and about the market? Because, if clients don’t understand the market, they will misinterpret signals and, combined with hair trigger emotions, they will make bad decisions. Advisors will then spend their time hand holding, rather than in more productive areas of their practices.

Over the last seven years, correlations within the US equity market have increased, as well as between US, developed, and emerging markets. How should advisors adjust asset allocations in response to this phenomenon?

Advisors must recognize that this is correct. Markets have become more correlated. Fear and anxiety, such as we are experiencing today, increase this correlation.

Everyone should diversify their portfolios. The benefits of diversification do not get reduced by stronger correlations, they just become less obvious.

Remember that diversification is for protection on the downside, not for improving upside potential. Diversification is critical because bad things do happen.



What role, if any, should active management play in the investment strategy of investors with long term horizons?

The basic reality is what Warren Buffett has said it true. For almost all investors, index funds are the highest quality, most reliable, best deal going because they are inexpensive. They take away the negative experience, anxiety, and worry associated with active management, especially over the long term.

By indexing, advisors are capturing the cumulative human experience and expertise of many, many investors. That's a real positive reality to remember and reflect upon.

When advisors index, they are getting the sum of best judgment of the best investors, especially institutional investors. These investors are doing the hard work for you. Consider this analogy. I fly a lot - perhaps five flights a week for the last 40 years. I have a perfect record. When I fly, I sit in my assigned seat, pull my seat belt tight, and never come anywhere near the pilot's cabin. The pilots know what they are doing, and I am not going to do be any better at flying the plane. I accept their best judgment.

The same is true in investing. If you believe – as I once did – that you are better at picking stocks, the odds are about 9-to-1 you are wrong. Investing is not unique in this respect. We overrate our abilities in all sorts of pursuits. About 80% of people believe they are above average dancers, conversationalists, and drivers. We are perennial optimists. Be careful when you apply the same logic to investing.

If you are really superior, and you are willing to invest the time, you might want to invest actively. But you are probably kidding yourself. If you really are unusually good, you should go in the investment business, which is a great business.

Keep in mind you are playing against the most capable people in the world. The question is not whether you are above average. It is whether your abilities are above the best of those that are investing professionally today. They are, in most cases, way above average so the bar is set very high.

The same logic applies to advisors picking actively managed funds. Very few people have been able to pick funds that will deliver superior performance in the future. Here, the past is definitely not prologue. While it's true that poor performers tend to continue to do poorly, the data says



clearly that for other funds, past results do not say much about the future. Not much at all. Picking funds based on their recent ability to deliver the highest rate of return will lead to disappointment. Instead, look for the funds that will not perform poorly. As Miss Walsh taught us in 7th grade, a non-negative is a positive – like non accidents for a teenage driver. The best analogy is to a father-in-law sizing up a potential son-in-law. Will that fellow be a good friend to your daughter, a good father, and a person of character? The principal objective in investing is to avoid screwing up. Look at who you will trust when the times get tough.

Advisors should actively manage portfolios only if they have first completely worked out the correct asset allocations for their clients. In addition, they must insure their clients, and those who influence them (e.g., spouses and family members) understand and agree it is the correct asset allocation and they know why the allocation is correct – so they can stay the course when current markets are disconcerting. It is very hard to get the right answer to this question of asset mix that's best for the particular investor over the longer term and this question is the only one that really counts.

You have been very critical of market timing as an investment strategy, particularly attempts to select individual securities at attractive prices. All the empirical data supports this view. But what about longer term cycles? Is it possible to predict cyclical economic trends and adjust portfolios proactively?

Yes, it is possible, but *not* probable – and not possible to do regularly. Nobody ever has. I don't believe in taking the time or effort or putting the money behind decisions that are not probable and costly and all too often seriously awry. It doesn't pay off. It is a waste of time and energy at best. It takes time away from enjoying life, and away from understanding yourself and time away from getting it right on asset mix.

It is like the third glass of wine. It won't do you any good. Nobody got smarter or better by drinking that third glass. It just affects your judgment.



In the first words of the foreword to the most recent edition of your book, *Winning the Loser's Game*, Vanguard CEO John Brennan says "It's different this time." He was referring to the upbeat – but ultimately misguided - investor sentiment during the bull markets of the 1980s and 1990s. We'd like to ask the same question, with regard to the sub-prime crisis. Will the effect of the sub-prime crisis be similar to that of other recent crises that have affected the US markets?

I have a very standard answer to this question. This time is always different, but only in details and specifics, and not at a fundamental level.

Every advisor should be thinking about investing for the long term, not the short term. In my lifetime, there have been five times when stocks have been substantially mis-priced; three times when they were underpriced and two where they were overpriced. If I had missed those opportunities it would not have done any harm to my portfolio in the long term. What would be really expensive would be to make a decision based on short-term signals and be out of the market when it was, as markets do, surprising the all-too-smart folks who were not investing, but speculating.

The sub-prime crisis is fascinating and highly complex. It has done great harm to young families. This is a real shame. The big financial institutions have been hurt, but they can live through it. As exciting as this may be now, the time to get negatively excited was a year or a year and a half ago. The time is not now. It has already been worked into the market.

Everything I know is known by the market and worked in to the market. The best way to invest is through benign neglect. Get your asset allocation right and leave your investments alone. Like a scab that forms over a wound, leave it alone and it will heal faster.

Advisors and their clients who take a long term view will live through today's turbulence. It is like the climate, which is extremely important when making the long term decision on choosing a place to live. We want a climate that is right for our current and planned life style, but we can't get hung up about the weather on a day-to-day basis. Rain storms happen. We get used to it.



With regard to your own investments, can you share with us how much is managed actively versus passively? And have you made any adjustments to your own investments as a result of the sub-prime crisis?

No changes due to sub-prime or to any other crisis – or to any “chance of a lifetime” because I have too much respect for the competition’s capabilities and have learned to be modest about mine.

I’ve owned Berkshire Hathaway for over 30 years so that has become significant *and* I’ve been entirely passive – and grateful to Warren Buffett. Candidly, he made the money so it’s all going to charity following Warren’s wonderful lead. All the rest is in Vanguard index funds – with pleasure!

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