Our Interview with Peter L. Bernstein

Peter L. Bernstein is President of Peter L. Bernstein, Inc., an economic consulting firm he founded in 1973. He is the publisher of *Economics and Portfolio Strategy*, a semi-monthly newsletter geared to institutional investors and sophisticated individual investors. Prior to this, he was the CEO of an institutional asset management firm. Mr. Bernstein is the author of nine books on investment management, and has won numerous awards for his scholarly articles. He is a regular contributor to the New York Times, and often writes for the Wall Street Journal and other publications.

Our questions are derived primarily from *Capital Ideas Evolving* (2007, John Wiley & Sons), Mr. Bernstein’s most recent book.

You discuss the concept of a “rational bubble,” which may be an oxymoron, but refers to situations where presumably smart investors follow a crowd into a bubble, with the expectation that they will know the right time to get out. Was the housing market a “rational bubble” and what is your outlook for the real estate market in general, over the next few years?

The housing market was the exact inverse of the rational bubble. It seems everybody shared the expectation that prices would never go down, and there would never be a need to get out. This is especially interesting, because not just the general public but also the most sophisticated investors in the financial markets exhibited this behavior. There is no way to explain the widespread miscalculation of risk in financial paper such as CDOs. The demand became so widespread, and the comfort level so high, that the market became an irrational bubble in the purest sense of the world. Anyone playing a rational bubble would have known when to get out.

You have great esteem for the proponents of Behavioral Finance, while acknowledging that many economists, such as Paul Samuelson, are much more skeptical about the ability of Behavioral Finance to generate results for investors. What is the bottom line – can Behavioral Finance be used to produce alpha?

If alpha exists as a result of mis-pricing related to risk perceptions, then you have to explain it from the behavioral side. Sometimes mis-pricings may be related to liquidity or other transitory events. But, on a consistent basis, excess return has to come in some shape or form from the behavioral side.
Otherwise alpha wouldn’t exist. If people didn’t let their emotions dominate, mis-pricings wouldn’t exist or would be ephemeral. If everybody read Kahneman and Twersky and acted accordingly we would have a fully efficient market.

Academic literature now documents ways behavioral finance can be used to produce alpha. For example, momentum is certainly a behavioral kind of thing.

One of the themes you address is the ability to identify skillful active managers in advance. You quote Samuelson as saying “There are a few Babe Ruths who can outearn the crowd…and I can’t identify that special few.” You also cite research showing that prior alpha can predict future alpha. Where do you stand on this issue, particularly with respect to financial advisors utilizing primarily mutual funds and separately managed accounts? Can they identify the skillful active managers in advance?

Some people claim truly skillful active managers exist, and claim they can identify them in advance. I believe they are few in number, limit their AUM, and charge high fees. With respect to financial advisors for individual investors, I am a great believer in indexing. Asset allocation is the primary way to improve performance for the individual investor.

Adding active management is very chancy. Even the best managers, like Bill Miller, have dry periods. Financial advisors can do much more good for their clients by concentrating on more important issues, such as asset allocation. The key questions are how should assets be allocated and how to get there at the lowest cost. I am a big supporter of John Bogle and have great respect for his emphasis on costs, and their negative impact on return. Minimizing management fees and turnover gives you a big head start.

You discuss the possible underlying causes of the LTCM market crash, which was widespread imitation of common investment strategies in the market, and a domino effect that took hold as some of these began to fail. Similar explanations have been offered for the volatility in August of 2007. How pervasive is this phenomenon, and what risks does it present for markets as a whole?
LTCM was not really aware of the degree their portfolio was the market. They woke up and discovered they could not move because everyone was trying to do the same thing. The philosopher Hegel said “quantitative changes ultimately become qualitative.” LTCM had become something very different from when it was unique. The responses of the market were entirely different from when they started, and they were undone by their own fame. August was an entirely different kind of environment, not comparable to the LTCM incident.

I’d like to ask a few questions about the Yale Endowment, whose investment prowess is held in great esteem by the advisory community. You argue that managing an endowment is more complex than for an individual, because of the need to satisfy the operating needs of the University, along with an infinite investment horizon. But individuals must deal with taxes and generational wealth transfer, and some would argue that a finite time horizon increases complexity, rather than decreases it. What really makes endowment management more complex?

Asset management for Individuals is an order of magnitude more difficult than for institutions. I managed money for 20 years, from 1951 to 1971, and 90% of the assets were from individuals. I know well what you mean.

Individual asset management is complex because of the many issues that play upon it, such as the passage of time and the dynamics of family relationships. For financial advisors, I believe the simpler you can make it, the better it is for clients. In this sense, indexing helps to remove volatility.

Institutions are under a lot of competitive pressure because their performance is measured against their peers. Individuals don’t have to get into that kind of a race, unless they want to discuss their performance at cocktail parties. I have many friends that compare returns, but I avoid those discussions.

But based on relative complexity, I would rather manage a university endowment. You got me on that one!

You quote Swensen as saying “the key to active portfolio management lies in giving the fund manager the freedom to determine his own style of investment management and to act independently and quickly.” For financial advisors, this would dictate avoiding the vast majority of funds that operate based on style box constraints. Do you believe that style-agnostic cap-agnostic approaches will produce better returns? Should advisors emulate Yale’s approach of using multiple sector-focused managers with highly concentrated positions?
Every institution I know now tries to replicate Yale. It has made things very difficult for Yale to continue to achieve the results they do.

My advice is not to try to imitate the Yale portfolio. Certainly, with individuals, there are ideas that can be imitated. But, institutions like Yale have huge staffs that are knowledgeable and sophisticated in many different disciplines. With individuals, especially taxable accounts, it is not worth it.

Swensen himself preaches that it is wrong for individuals to take the “Yale approach” in his book (Unconventional Success: A Personal Approach to Investment Management, Free Press, 2005).

With regard to managers and style boxes, I am not in favor of active management. Diversification must come first. Yale can take their approach because diversification is set and public equities are a relatively small part (less than 10%) of their portfolio. It won’t disturb the rest of their portfolio. For individuals, you must use style boxes or their equivalent because diversification is so important. Advisors can give a little money to someone who is a free wheeler. But diversification is the primary form of risk management.

Swensen employs a very proactive approach to portfolio rebalancing, which you liken to market timing (although mechanical, rather than a matter of judgment). What role should market timing play in the management of individual portfolios?

I have nothing original to say on this. That it is hard is meaningless – all investment strategies are hard to implement. The big problem is breadth – even if you have skill, you will use it relatively infrequently, and you are inevitably going to be wrong at some point, so your average may have too few components to let your skill add value.

One of the pervasive themes in your book is that CAPM has been very effective at the institutional level, and has been at the core of successful strategies at places like Yale, Barclays, Goldman, and TIAA-CREF. But it seems that many of the legendary investors, like Peter Lynch or Warren Buffett, probably have (or had) no idea of the beta of their portfolio or where it sits relative to the efficient frontier. How do you account for the success of these value-based investors who operate with a seeming disregard for Capital Ideas?
CAPM is not a guide to valuation. It was originally set up as a way to value financial assets, like stocks. On that score it is a disaster. CAPM focuses attention on two parts of the process: asset allocation and evaluating efforts to beat market. Mark Kritzman, a Senior Partner at State Street Management, wrote an article for the newsletter I publish. He shows that conventional active managers are actually charging higher fees than hedge funds. When you hire an active equity manager, you get a high correlation to the S&P 500. So, a lot of what you pay is for beta. You get relatively little alpha. With hedge funds, the correlation to the S&P 500 is relatively small. Virtually the whole fee you pay is for performance, so the hedge fund becomes less expensive. It is a clever piece of work and focuses attention on the nature of active management fees. You get what you pay for, and CAPM is at the heart of this analysis.

You discuss “dragon risks,” a term which relates to a period where explorers were afraid of the unknown – whether the world was flat or a flame-throwing dragon lurked around the corner. You suggest that these unsystematic and un-identifiable risks are why institutions do not make even bigger bets on asset classes, like alternative assets, that have better historical risk-return characteristics. Do you believe that institutions are acting optimally in this respect?

Institutions are probably not acting rationally. They have gone too far into alternatives. I had lunch a week ago with the Chief Investment Officer of a big charitable foundation. They have less than 10% of their portfolio in bonds, because they use alternatives to fill that role. What we are going through at this very instant [with the credit crisis] will determine, when dust settles, whether they are right. As an old fashioned investor, I believe they will be sorry with their overexposure to alternative assets.

The way to deal with dragon risks is to be hedged. The goal is to survive, and this is more important than a high return. Investors will earn returns over time. But do not get caught with your pants down. I hold a little gold. With the turbulent currency market, the conditions are in place for a dollar crisis. As much as I hate owning gold, I want to survive, so I hold gold. I am diversified as much as possible.
Is there any specific advice you can offer to financial advisors that manage assets for younger clients?

I learned from managing individual money that investors with small portfolios, relative to other assets, take too little risk. Their overriding criterion is the consequences of loss. But when you are young you can afford a loss. Shooting the moon and losing is not terrible. But making a killing makes an enormous difference. The fear of regret is weighted too highly. Investors can take risk through higher equity allocations, exposure to small cap and international stocks, and by being less diversified.

A long time ago I gave a talk at the New School of Social Research. A man – not too well dressed - came up afterwards and asked if we were looking for a new client. I said “sure, send us your portfolio.” He owned only three stocks, like U.S. Steel, that he had bought on margin and now had big profits - on the order of $150,000. He was doing very well, so we asked him why needed us. He was a reporter with the Brooklyn Eagle, and he was losing his job because it was going out of business. Had only $15,000 in the bank and was going to be broke in a year. But, with his investment success, he had a comfortable amount. He took the right risks at the right time, and it paid off. I learned a lot from that person, and I think about it often.

Where do you expect to see the greatest innovations in the capital markets over the next ten years?

I have no answer to this question. We went for a long time with no real innovation. The big innovation in my lifetime was Black Scholes, which added a whole new dimension to the options market. I can’t conceive of anything of that order of magnitude.

I’d like to ask one question on the state of the markets today, since we have seen a nearly 10% drop in less than one month. At current P/E ratios of approximately 15, do you believe that the S&P is fairly valued?

We’re not at 15 any more! [On the morning of this interview the Dow had dropped approximately 450 points at the open.] At the top of the market [in October 2007] the market was surely not as overvalued as it had been in other major bull markets, not only in an absolute sense (with respect to P/E ratios) but also relative to the bond market. It is really weird to see this much decline in a market that was not overvalued. Robert Shiller (professor of finance at Yale) does not believe in instantaneous P/Es, and says we should look at ten year historical averages [Ed. Note: See our article on this subject]. It is tough to apply his analysis now because of the impact of the dot com

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disaster on the average of EPS over the past ten years. Even so, we are back very close to long term average P/E levels. Even by Shiller's measure, which is a pretty tough criterion, the market looked okay.

The lack of overvaluation gives a sense of the big problem we are facing in economy. It is more than a recession; the whole financial system is trembling. Banks have seized up. The issuance of financial engineering paper will shrink, and will take a long time to regenerate the appetite for risk we have seen in last five years, with lots of credit. The opportunity for growth is real scarce. The household sector debt hanging over us is scary. I don't know how bad it is, but it isn't going to be good for a while, until we work out of this.

I wrote last year that too many people didn’t think we were in a low risk environment, so they took big risks. I didn’t see how the market would unravel, even from the level of a general sequence of events. I have not seen anything like this.

Can you tell us how your own money is invested, at least at a broad asset class level, and whether it is invested passively or actively?

I hold both stocks and bonds in a very plain vanilla portfolio, including some very old positions. I am passively invested, except for some municipal bond mutual funds. I don't want to have to spend a lot of time thinking about my portfolio. It is very well diversified. I guess I am following in the steps of Harry Markowitz, the pioneer of modern financial theory. When he was asked by TIAA-CREF how to split his assets between stocks and bonds, he said "just do it 50/50!"

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