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To Cut, Or Not To Cut

To assist a friend, I ask reader support and advice. Here is the situation:

My friend, a 58-year-old investment professional, does not have much hair on his head. However, he has had some success with a small crop emanating from the right rear. This small crop has grown spectacularly for, if carefully positioned, it can be made to cover a substantial portion of otherwise bare surface. With the assistance of Helene Curtis, extra hold, unscented finishing spray, he has reasonable assurance that the small crop will provide sufficient coverage to render a professional appearance, except

. . .on windy days, when strands fly around everywhere, chaotically, completely out of control. On such days, his younger children have been known to express keen embarrassment to their mother, who consoles them by saying, "Well, that's Dad." Meanwhile, Dad's problems are more than cosmetic, because the extra long strands get into his eyes and otherwise cause physical discom-

fort while skiing or boating. Hence, he asked me this question:

"Should I continue laboring with brush and spray to maintain this image, with which I am immensely comfortable, or should I shave it all off?"

Readers can offer opinions by calling 317-228-0800. Responses will be kept in strictest confidence.



Performance Measurement and the Exercise of Fiduciary Responsibility

[This pertains to trustees who are responsible for institutional accounts, such as endowments, and foundations that routinely purchase performance information from consultants.]

Charging investment accounts for performance measurement abrogates a fiduciary responsibility.

“No way,” you say. “Measuring performance is required, by custom, common sense, and ERISA. Evaluation of performance information is the major agenda item for all committee meetings. We need this data.”

And I respond: *Past performance is not a guarantee of future results.* No study or personal experience proves a connection between the past and the future. The normal chaos of life severs connections between past and future. Data about past results of Ms. Smith of XYZ Capital Management loses all relevance if her next strategy fails, or if she retires, becomes disabled, or passes away. What should we think about The Magellan Fund after Peter Lynch retired? What would we have thought had he stayed? How do we know that success will follow success? We don't. And so, spending thousands of dollars to precisely

measure and to report past investment results, and dedicating thousands of hours of committee time to evaluate performance information, are as nonutilitarian as a perusal of yesterday's sports data that is available in newspapers—for fifty cents.

Nevertheless, investment committees believe that they have a fiduciary obligation to receive and to consider performance information. They feel that the modern definition of prudence includes a requirement to measure performance as part of standard procedure. They also believe that procedure is the most important criterion to determine whether a committee has acted prudently. Taken to the absurd, an investment committee that experiences losses every year may be considered to have acted prudently if those losses were incurred through a prescribed procedure. Printed guides and texts usually list performance monitoring as a required procedure. The result is that most investment committees retain a consultant to provide performance information. Small accounts pay hundreds or thousands of dollars for this information, and large accounts pay tens of thousands. Additional fees might be incurred if performance information is audited. Often, the information provided by consultants and auditors duplicates information generated internally by investment managers. Reliance on managers' internally generated information has no extra cost to the investment committee. Since performance information is available from managers, investment committees that pay for independent data are wasting money. They violate a fiduciary obligation to reduce expenses of investment management.

Fiduciary obligations are not uniform. From one account to another, from one situation to the next, the fidu-

ciary has a different magnitude of responsibility. The most weighty obligation is held by the trustee or guardian of an individual, because a financial failure caused by decisions of the trustee has momentous consequences. The life style and personal health and well-being of a ward or beneficiary is seriously compromised when all of his or her assets are mismanaged. Until the creation of institutions for the welfare of groups, the prudent man theory applied to the relationship between a trustee and beneficiary. For them, only tangible results mattered. The question was whether the trustee preserved assets that benefit the beneficiary. Performance information was irrelevant. No one cared if assets in trust earned 5 percent or 5.2 percent. Observers then could not imagine that such a distinction is meaningful, and they would not have allocated resources to the labor of generating precise, standard, unimpeachable rate-of-return statistics. They were concerned only about preserving assets and maintaining a life style, objectives easily measured by the answer to this question: Does the beneficiary have enough income to live a satisfactory life? Life itself was the measure. Academic statistics were unknown, for who in the 18th and 19th centuries would have spent hours hand calculating time-weighted numbers based on monthly appraisals carefully linked to reveal an annualized rate of return? Who could then have imagined creation of a national investment management organization to police creation and presentation of such numbers? At the close of the twentieth century, relationships between trustees and individual beneficiaries are measured the same way as in previous centuries. The trustee accomplishes his/her job if the beneficiary's financial circumstances are steady and

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A Vacation Begins . . .

on the third day. Hence, a three-day vacation must be six days long.

Whether hiking the Smokies, sailing the Chesapeake, or visiting relatives, the traveler needs three days to adjust. On the first day, the traveler's mind cannot escape routine. The mind asks, "What did I forget? Did I turn down the heat, leave the key with a neighbor, and stop the newspaper? Will that check be in the mail? Will the automobile rental and hotel room be available? What can I read on the plane? What about the business deal I have been negotiating?"

By the second day, thoughts begin to change. The mind magically adjusts to new circumstances. While anxiety still lurks below the surface, it no longer grates. A new tranquillity appears, and feelings of guilt diminish. It now is OK to rise at 7, to put head on the pillow at 10. And then, the third day, the wonderful day on which a vacation begins. The mind now enjoys two-hour conver-

sations about nothing, and three guilt-free hours at a museum or movie house. It remembers techniques learned, but temporarily forgotten, like how to drop anchor or to prepare food in the outdoors. The mind also begins to ignore perceived discomfort, like the motel mattress and small shower, or the hard ground under a tent.

The body, too, is acclimating. Motion sickness for a sailor, blisters and cold for the hiker, or aches and pains from walking urban sidewalks, diminish or disappear, at least in relative importance to the joy of the new activity. On the third day, the mind and body no longer resist. Instead, they accept. They even begin to enjoy. At that unseen, unnoticed moment on the third day, the new life beings. The vacation replaces real life. Now the traveler appreciates the opportunities in a trip.

Followers of The Third Day Rule are devoted both to the rule and to its en-

thusiasts. Third Day Rulers never meet, seldom correspond, rarely discuss their guiding principles, but they do feel pain for nonbelievers. They know that the person who dislikes sailing probably experienced only motion sickness, not the rewards of sticking it out until the sickness goes away. They suspect that the "I-only-sleep-in-Holiday-Inns" crowd never remained in the forest long enough to appreciate its beauty or the fabulous taste of a rustic outdoor meal. Even the annual-short-trip-to-the-relatives group probably misses opportunities for the meaningful one-on-ones that tend to take place days after the welcoming ceremonies, when tiredness and tension are gone.

Famous investor/diplomat Bernard Baruch said that everyone (especially investors) needs time to think and to relax. He took a month every year. (He could afford it.) Watching stock prices can be an exhausting addiction, while abandoning the routine requires at least

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Would you believe that . . .

- over 45 percent of those leaving high school graduate from college in four years, the highest percentage ever recorded. (I thought that the five-year plan was common.) The low was just over 10 percent about 1945.
- the Russian stock market was up 294 percent in 1999.
- the average holding period of all publicly held shares of Amazon.com and Yahoo common stock has been eight days.
- 21 percent of investors check their net worth more than once each day.

[This column recalls inaccurate predictions or conventional wisdom. Its purpose is to demonstrate that predictions are inaccurate.]

Chaos

To say that the present market is "absurd" is not to say that it will decline or crash. Present absurdity is not future catastrophe. Instead, the adjective represents only a description of the present.

Nevertheless, this market, or at least parts of it, is absurd. For example, on December 10, shares of Freemarkets, an on-line auctioneer for industrial products, jumped 483 percent from its initial offering price. The day before, VA Linux had an eight-fold increase. Such activity is nonsense. Professional investment bankers utilizing the best in valuation theory establish the initial price in negotiations with officers of companies. Initial prices are considered reasonable, prudent, acceptable and defensible, but the moment these speculative shares enter the market, wow!

A second "absurdity" is responses to the actions of statisticians. Share prices increase or decrease because committees of statisticians at Standard and Poor's or another information machine declare that a stock does or does not belong in an index. What has this got to do with value? Does the value of a company change in 24 hours because four or five analysts conclude that its shares should be in an index of 500 securities? Of course not. Sales, profits and asset values are the same the day before as the day after.

Performance Measurement, *continued from page 3*

secure. This obligation to protect another individual is the highest fiduciary obligation.

The next important fiduciary obligation is to groups, such as those found in retirement plans. This responsibility is more complex. It is both wide and dispersed. This responsibility is wide because it extends to a group instead of to one ward or beneficiary. The dollar responsibility is immense, but the amount attributable to each beneficiary is moderate. The party holding the fiduciary obligation usually is an investment committee, a group of executives, employees and professional investors who direct policies of the retirement plan. In the modern structure, beneficiaries may sue the sponsor, committee members as individuals, or investment managers and consultants. Payments from successful suits ameliorate personal damage to individuals. In addition, beneficiaries may seek relief from the pension insurance system. A second factor in measuring the weight of fiduciary responsibility is that retirement plan beneficiaries are unlikely to face financial catastrophe or a major change in lifestyle if a retirement plan performs poorly. For most, nonretirement assets and the Social Security system provide a blanket of comfort. Persons damaged by poor retirement plan results might cut back personal expenses, but not to the point of strangulation. Sophisticated, precise measurement and presentation of rate-of-return statistics has little meaning to retirement plan beneficiaries. A percentage point here or there over five or more decades of a working career has no more per-

sonal financial significance than World Series results. For retirement plans offering multiple investment choices, the prominently displayed rate-of-return numbers confuse. These numbers dissuade employees from making choices based on philosophy instead of on past rate of return. The data encourage reliance on the past, even though *past performance is not a guarantee of future results*. Sponsors should eliminate performance information from brochures describing investment choices. Assuming additional expense to prepare or to audit these statistics is a waste.

The last and weakest fiduciary responsibility is that of an investment committee responsible for a foundation (or endowment). This responsibility bears no relationship to the obligation of trustees to protect the lives of individuals, because the connection between the investment program of an endowment and the beneficiaries of endowment income is tenuous and variable. For example, foundations make short-term grants. They commit to projects for only a few years, and the history of foundation activity suggests that no project sponsor should permanently rely on grants from one or two foundations. Most institutional donors so state in their contracts with donees. In turn, donees, such as The Boy Scouts or The Ballet, work hard to reduce reliance on a single donor so that the institutional life of the organization will survive inevitable changes in donor giving policies. While the life of a ward changes immediately on a reduction of trust income, the institutional life of The Boy Scouts is unlikely to change if one foun-

dation stops giving. Hence, the investment trustees of a foundation do not carry a weighty fiduciary responsibility. Poor performance does not have a profound effect.

The fiduciary obligation of foundation investment trustees, while weak, extends in two directions. One obligation is to donees. This is the obligation to pay promised amounts. The other responsibility is to grantors and donors. Organizations must budget so that donations are not wasted. United Ways, symphonies, museums, universities and arts organizations scramble hard for \$1,000 annual donations. Significant staff and volunteer time is devoted to soliciting these gifts, and \$1,000 donors are rewarded by "club membership," plaques and cups. Meanwhile, investment committees representing endowments of these organizations spend tens of thousands of dollars annually on performance measurement, usually without debate. Committees receive colorful graphs and complex tables relating managers' performance to indexes, risk concepts, and to other managers. Over ten years, money saved by eliminating excess performance data expense would add up to a healthy and much-coveted grant to build a swimming shelter or to present a live stage production. Because *past performance is not a guarantee of future results*, spending to measure the past is a waste. It is a violation of a fiduciary obligation to both donors and to donees.

Vacation, *continued from p. 3*

three days of winding down. Only then does the investor begin to escape routine, to gain perspective, to see new opportunities. Thinking time is profitable time. The best thinking occurs on a vacation, after the third day.

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