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INSIGHTS

"Insights" features the thoughts and views of the top authorities from academia and the profession. This section offers unique perspectives from the leading minds in investment management.

INTERVIEW WITH DEAN LEBARON AND CHARLEY ELLIS

As part of our twentieth anniversary of the JOIM, I have asked a few luminaries to share their sage thoughts in our "Insights" section. The following contribution is from Dean LeBaron who also enlisted comments from Charley Ellis in an interview which preceded our publication. My thanks to Dean and Charlie for their thoughtful input to the historical perspective of investment management.

Gratefully,

Gifford Fong

Editor

Sheila Ohland, CEO of Zurich CFA Society:

Starting with bold and controversial insights 50 years ago, the men who invented index funds reshaped financial markets and investing practices.

I'm delighted to welcome our moderator, *Financial Times*' global finance correspondent Robin Wigglesworth, who focuses on the most significant trends reshaping markets, investing, and finance worldwide. He's the author of the book *Trillions*, which investigates how a band of Wall Street renegades invented index funds and changed finance forever.

Robin Wigglesworth

Thank you very much for that kind introduction, Sheila. Hello everybody. I don't think our guests need much introduction.

As Sheila mentioned, I wrote a book called *Trillions* about the Wall Street renegades who invented index funds. Dean LeBaron is one of those renegades.

In researching that book, I came across a speech he gave to financial analysts in Atlanta in 1975. I will read a section that I found both evocative and eerily prescient.

"What we are witnessing today is the slow, almost imperceptible motion of a growing, deep ocean swell that will form into a massive wave as it hits the investment beaches.

"Just as the surfer looks outwards to the sea to observe the swells so that he may judge the wave to come, he does not look at the beach to see what has already gone by, so should we become sensitive to the build-up of a wave of mechanical strategies that are in progress today."

I think Dean's observation was on the money and ahead of its time since he had only been running an S&P 500 index portfolio for a year in 1975. It was a great way of visualizing what was to come before many other people realized it, though Charley here is one of the few people who anticipated what was coming.

Given that times have changed a lot, I'd love to hear how you both started in the investment industry. How did people come into this world in the 1960s? Charley, can you kick us off? How did you end up in the wonderfully fascinating world of investment management?

Charley:

It was sheer luck. I was attending Harvard Business School, but there were no classes or courses in investment management, and only three people from my graduating class went to Wall Street. One went into investment banking, and one went into investment management. I tagged along.

How I happened to get a job was even more absurd than that. A friend asked, "Have you got a job yet?" I said, "No. I've got a couple of possibilities, but nothing firm."

He said, "Well, maybe you'd like to work with a friend of my father who works at the Rockefeller outfit." I thought, "Well, the Rockefeller Foundation could be interesting work because I managed an educational radio station before going to business school, and maybe that's the right area of the world to focus on."

He said, "No, no, not the foundation. The family and their fortune!"

After half an hour, I realized that if I worked for this highly intelligent man, I would learn a great deal, but I needed to figure out what he did for a living because I didn't think it had to do with giving money away. In the next half hour, I discovered he was talking about investing, and at the end of the hour, he asked if I'd like to join them, and I said, "Yes." Since then, I've had an extraordinarily privileged career in the world of investment management.

Robin to Dean:

It's been pretty incredible. Dean, you also started in the '60s, right? Was your entry quite so fortuitous?

Dean:

I started about the same time. My story is slightly different than Charley's, but it parallels his. We have been friends for 60 years, and together we have done various things - sensible and foolish, and about equally balanced between the two. I went into the investment business because success or failure would be easy to determine in a reasonably short span. My first summer job for what was then White, Weld & Co. in New York was to be the sole expert on fiberglass boats, and I followed that by becoming the nation's expert on commercial aircraft.

Early on, I also had a job with the Rockefeller family - 4th generation - and they liked to know how they were doing month by month. The way

I would tell them is I would show up wearing a green suit. And they thought that was terrific: As soon as I'd walk through the door, they knew we were doing fine that month.

I - and they - liked the immediacy of that response, and since then, I've been looking for a sensible way to measure investment returns in the short term. In preparing for this conversation, I looked back at what I wrote sixty years ago. The shocking thing is that my thoughts haven't changed much. I learned very little this whole time. Sixty years ago, I asked the same questions I'm asking today: What's significant and what isn't? And how are things changing if they are? What can we intelligently predict? And what can we not?

Robin:

A lot of things certainly have changed. Charley, what are the most significant changes from when you started and the markets today? I know you guys are still very keen observers of the current environment. What do you think about this evolution? Is it good or bad?

Charley:

First, Robin, trading volume has increased dramatically. Sixty years ago, 3 million shares were a big day on the New York Stock Exchange. Today's volume is somewhere between 6 and 8 billion - an unbelievable surge. Even more important, the percentage traded by professionals has gone from 9 percent to about 90 percent, and those professionals have also changed dramatically. They're much more educated. They've got much more equipment and access to information. In our day, there were 14,000 commercial banks. A large fraction of them - 3,000 or 4000 - had trust departments, working primarily with individuals to avoid taxes, generate high dividends for the current beneficiary, and appreciation for later ones. In those days, you bought blue-chip stocks and held them forever, so trading was minimal. Then volume exploded. Back then, we used slide rules, and we could call and ask what the latest price on IBM or General Motors or any other stock we wanted to know.

Today, everybody has a Bloomberg Terminal. Some people have one at home, one at work, and one in the car, which means they've got non-stop access to information. Everybody has the internet, which provides worldwide access to virtually every kind of information instantaneously. Most countries have regulations regarding fair disclosure, which means that nobody gets any comparative advantage. Years ago, we used to go to private dinners and be told all sorts of privileged information. That was a major competitive advantage that's been eliminated because it's not fair and, therefore, against the law. Then there are the advances in technology and equipment: Most people have smartphones that have more power than an IBM 360, which was a great sensation 50 to 60 years ago. Go through all those changes, and you would have to argue that the world of investing has been transformed. Until a few years ago, every nation had its own investment market, and people who lived there invested solely in that country. Today, everybody invests globally. Sixty years ago, Goldman Sachs had no published research. They now have some 300,000 people doing an unbelievable amount of research, and it is just one of two dozen major organizations. The number of professionals in investment management might have been as many as 5,000. Now it's well over 500,000 and may be as many as a million. And the education level of these individuals has increased from high school - or maybe undergraduate school - to an MBA, CFA, a PhD, or an MD PhD. The amount of sheer brainpower being brought in by each individual is tremendous.

When you put all of those together and multiply them, you realize two things have taken place. One is an extraordinary transformation of the markets. Two is that investors are more and more equal and equipment is more dominant. So if you look at all those compounding factors, you'd have to admit the world of investment management has changed dramatically.

Robin:

Dean, take us back to the '70s.

Dean:

There are two strata of indexing in this regard. One is if you want to be different, meaning better, then be different. Run a different portfolio, run a portfolio that no one else would. But, two, if you wanted to have the same portfolio that we had - the closet index portfolio - do it and save money in the process. It's the cheapskate's approach, and I'm still a cheapskate. The key with indexing wasn't so much that it was superior in terms of return but that investors could save money by putting it in place and forgetting about it. Overall, it was a money-saving tool, and the savings accumulated. However, once everybody gets the same tools that Charley so well enumerated, no professional investor has any particular advantage over any other. So you might as well admit that you can't do any better than anybody else.

My advice to investment professionals today is to forget what you have learned. Walk into a meeting as blank-minded as possible and say, "I'd better be sensitive to what's new." For example, some firms asked, can we can pay the New York Stock Exchange to tap into their trading lines a millisecond earlier than other people? The answer was yes, and about 75 percent of the big trades now occur in the so-called dark market. That's horrifying to me, but today, it's business as usual. So what we old guys have to learn is to come in with a blank mind and start again.

Robin:

There's a lot of interesting stuff going on in private markets, and I think the blank-slate idea is interesting - it echoes something I've heard Stan Druckenmiller say as well, that when he started, he was given an inordinate amount of risk for a young trader because the senior partner said, "We have too much baggage, so let the young guns ride a little bit." But, interestingly, you didn't come into indexing as a huge believer - it was just an engineering product. It was something clients wanted. I know the other two pioneers who came into it. Rex Sinquefield of American National Bank in Chicago was a true believer. He'd studied under Eugene Fama. He believed markets were efficient - are efficient, he still believes it - while Mac McQuown at Wells Fargo was more like you. We want the optimal balance between risk and return, and an index fund is a reasonably cheap, simple way of achieving that. But the data was already pretty irrefutable by the '70s. Why did it take so long for indexing to take off?

Charley:

If you look at how many people are indexing and how many people are not, you'd have to say this is astonishing. The surprising thing is how slow we are even now to index, and one of the reasons, Robin, is that nobody looks at the terrible handicaps of active investing. You've also got significant operating costs, and people say, "No, they're not. They're not. The trading liquidity is terrific." That's true most of the time. But every year, there are times when the markets move a great deal and the costs of doing that particular transaction turn out to be rather large, so suddenly you realize, jeepers! The price of trading is pretty high! Then, of course, fees are very high, but the way people look at fees - as a percentage of assets - they're low. You already have the assets. What are you getting from the investment manager? Well, I'm getting a higher return. Okay, how much higher of a return are you earning? I would guess 100 or 200 basis points. So if the fee you're paying is half of your highest estimate and 100 percent of your lowest estimate, take a look at the data that SPIVA has collected over the last twenty years and see what percentage of mutual funds outperform the market benchmark they were targeting. They were free to choose whatever target they wanted - small cap, large cap, growth, value, any type of investment. And they could organize their business any way they wanted, hire the people they wanted, get the equipment they wanted, choose the source of information they wanted, and follow the process they wanted. What percentage of them do better than the index?

The answer is about 15 percent. About 15 percent do better than the market they chose. Those that do worse do substantially worse - if I can coin a phrase - much worse than the good guys do at beating the market. So if you did a slugging average, you realize, boy, this is terrible. The 15 percent that winds up doing better than the market does so with a small margin. Those that fall short do so by a substantial margin. This is a loaded deck.

So, how many people understand that reality? The answer is not very many, it's hard to overcome costs of operations and dealer spreads and, for individuals, taxes, in today's professionalized market. But changing managers is expensive, and investors don't always make the best choices. So add all those different things together, and you've got a very high hurdle to overcome. No wonder it seldom is.

Robin:

Yes, that's true.

I remember reading "The Loser's Game" that you wrote in 1975 that first articulated a lot of this stuff, and it's gotten worse since then. My favorite example was Chase Coleman at Tiger Global, who made an astonishing 48 percent gain in 2020, netting him - personally - $2.5 billion. But lo and behold, in 2021, he lost 7 percent in the first quarter. He's now down by 34 percent, meaning that his entire haul from 2020 has been lost for investors, then nets down since 2019. But the economics of investment management are still very favorable. Trading costs may be down, but salaries are up.

But, Dean, you're a very successful active manager, and you pioneered going into emerging markets in Russia, which is back in the news again. What are your perspectives on whether active management is doomed to underperform in the long run, and what can active managers do to perform better? Is there a point where we see active management stage a comeback?

Dean:

The answer to your good question is yes. And I have expanded on that a little bit. Now I have an opportunity to tell a few secrets because many of my friends who would deny what I said happened in meetings years ago are no longer with us. One of those meetings was during a two- or three-year period when the CFA committee deliberated on whether or not there should be some CFA standards about performance measurement that applied to what we thought of as our profession. And they concluded that, yes, there should be, but then they stopped, and we stopped. The idea was that if we should have a CFA standard, how would we use past performance data? And how should the data be put together? Should there be some standards for which information would be included, which would not, and why? And the "why" was particularly important. We rejected the notion that past data should be ignored and left it standing that past data should be it. And that's what happened. We used past performance data to conclude whether or not we should continue to be hired.

One of the things I was going to do - but I don't think I will because it's too foolish - is to come up with a forecast, which I would never have done 40 years ago, of how major industries might change in the 45 years beginning in 2020. As you go through a very painful transition - and if anyone doesn't feel that today is a painful transition, I encourage them to watch 5 minutes of any TV news program and see if they can stand it on a full stomach. We are in a new period, and I again plead for a fresh mind.

Robin:

Forty-five-year predictions are tricky, but they may be easier than one-year predictions. I was my favorite example. I think that markets are inefficient, and smart people can outperform, but it isn't as easy as people think. My favorite example was 2020. Imagine if the voice of God had whispered to you that we'd have this massive global pandemic that would rip a hole in the entire economy of the world and cause all sorts of issues. Even if you knew what was happening, you could not have predicted what markets would have done in response, so it's humbling.

Dean:

Here comes the Black Swan. Who's looking for Black Swans? I haven't heard anyone outside the mathematics community say there isn't such a thing as a Black Swan. Now, if Ukraine isn't a Black Swan, I don't know what it is, and they'll probably be a number of them.

Robin:

Some scientists call them grey rhinos in that they're not necessarily Black-Swan stuff that we didn't think existed. However, some obvious risks are easy to ignore because they're just standing still, but you care when they suddenly start charging you down, like a grey rhino. It's very slow and boring and easy to ignore until it's coming right at you, like the Russia-Ukraine situation. One of our viewers, Ralph Verni, is wondering about the shift to customized indices, or direct indexing, not just for ultra-high-net-worth individuals but also for high-net-worth middle-class individuals. Ralph wants to know whether these are index funds or a version of active management? Charley, what do you think about direct indexing?

Charley:

First, define what an index is. Then ask if there is an active management role. And if I don't get back to it, would you please ask me about the active management role because I think it's important. There are more indexes today than there are listed securities.

Robin:

Yes, by a considerable margin. There are 3 million indices and only some 40,000 stocks.

Charley:

Yes, it's just astonishing. So if you said, hey, this guy's got seven new indexes. Should I take that as a significant change? I wouldn't think so. Could it be significant for individuals? That depends on who they are and what they're trying to accomplish. If the index provider is charging a fee and this particular index takes off, they'll be able to collect a substantial income from it. So that's one part. And if you'd like to have a custom-tailored index, all you have to do is give me a rough idea of your body size, height, and weight. I can cut it out, and Dean could have his green suit back again. We can do almost any kind of tailoring you'd like.

Robin:

And on the active management side?

Charley:

People have defined active investing as changing the portfolio considerably. And that's the one part of active investing that doesn't have any real value to add, but other parts are essential. One is your investment objective. Most investors - be they individuals or institutions - haven't figured that out. But if you do figure that out, it can transform your investment program. So, determining your objective is an active activity. Choosing how to reach that objective is an active question, even when you select indexing as the most obvious way to achieve it. That's an active decision on your part. If you decide that you're going to re-balance the portfolio from time to time, fine, but that's an active decision, and the most crucial part of the decision is to choose an objective, design a strategy to get there, and then hold onto the strategy that you have chosen. I'm actively involved in selecting indexes, and I'm very enthusiastic about long-term, objective setting and using indexing to get that done. But it's an active decision. Let me give you an example. For fifty-seven years, I have not owned any fixed-income securities. I can hear you say, "Charley, you gotta be kidding. You're almost 85. At 85, you should be primarily fixed income investing." Well, Robin, I continue to work and enjoy earning a living, so I don't need stability, and I'm not investing for me, my wife, and not even my children, but for my grandchildren, and they have every expectation that I'll do what's right for them. And since their average age is 14, why would I buy any bonds if I had another 80 years, 70 years to go? The answer is: I wouldn't. I'd buy all equities, even though I'm almost 85.

Robin:

Well, that's wise if you're investing for the grandkids. Frankly, it's one of the things that I find myself screwing up all the time. The whole idea of active investing and passive investing is bogus because as soon as you start scratching below the surface, you realize that these terms are almost meaningless.

Charley:

Could I take up on that just for a minute? You mentioned active and passive, and you had previously mentioned Mac McQuown. Mac was an engineer by training. And that's the approach he took in the work he did at Wells Fargo. If you're an electrical engineer, you know a lot about electrical plugs. There's a wall socket and a plug with two or three prongs at the end of a wire. The two or three prongs are the active part, and the socket in the wall is the passive. There is no negative connotation to passive.

But take that terminology out of engineering and bring it into the world of, let's say, liberal arts. Then people really do care. They've got strong feelings attached to active and passive. For example, can you imagine how Dean LeBaron would feel if we all agreed Dean is passive? He'd be offended. He'd be deeply upset. If you run for political office and say, "Vote for me because I'm passive," you wouldn't have a chance. Most of us would be offended if our friends called us passive people. We like to be active. Yes, so we've got a connotation that we put on something that was innocent when it was being used in the original definition. So the only reason passive has taken such a long time to get accepted is that too many people use the term passive instead of indexing, which has no emotional connotation. Still, nobody ever got appointed to any position in a major Swiss bank or any other role of consequence in an investment firm by saying, "Go with me. I'm passive."

Robin:

Not a word with necessarily positive connotations, but keep fighting the good fight, Charley. Michael Milken's crew eventually rebranded junk bonds into high yield, so the phrase still seeps into usage and financial agendas, where junk bonds sound more interesting. But the industry calls it high yields. I also like index investing. Even index investing sounds kind of almost boring and technical. Maybe that's a good thing. You know you'll outperform most pros in the long run. And then it sounds a lot better.

Robin:

Now, I will try and get some disagreement going to keep things spicy. Another guy who's been talking and thinking about this for a while is Elliot Management's Paul Singer, who wrote a very acerbic letter about index investing or passive investing - whatever we want to call it - and called it a blob devouring capitalism. He complained it engendered corporate laziness because passive funds ruined capital markets' price discovery role. Today, one anonymous attendee asks, "Is there a stage at which index investing becomes unsustainable and unhealthy for markets or the economy? And can we get to a point where it's 100 percent passive, and there's no price discovery?"

Charley:

When we get rid of the people who spend all of their time and talent trying to find ways to compete more successfully. When we have an enormous outward migration of talented people from active investing, we are back to the few 100 - maybe a few thousand. When we bring back amateurs to dominate the markets and don't have information access. All those changes take us back to where we were years and years ago. Then active investing is going to have an incredible opportunity to do well. It won't be as easy as before the results were measured, but it will be a real opportunity. I think of a very talented investor with a very nice business as an investment professional who's done something almost nobody else can do. He's put together a team of some half dozen experienced analysts who understand certain industries remarkably well, and they're only going after stocks nobody else is following. They take three to five years and get to know those companies well. They create a portfolio of twenty-five or thirty securities they think have an opportunity to do better as businesses. They insist that their clients remember that they are to be measured not daily, weekly, monthly, or even annually, but every three, four, or five years because their market comparisons don't show up in shorter intervals. If they carefully choose their clients and their clients carefully select them, they will have a wonderful working relationship, and they will outperform. But if they took ordinary investors, they would gain clients like gangbusters for a year but then lose them in large numbers in the succeeding year because it's the wrong time frame. And if they don't have clients who understand that they're investing in companies that nobody ever heard of, they won't be able to get the understanding from their clients that the clients need to have. So it wouldn't work.

Dean:

Jack Bogle [founder and CEO of Vanguard], who's not with us anymore, would enter this conversation by saying indexing is fine. But he would not explain that the way index funds run their tracking periods - day by day, quarter by quarter - is flawed for investment managers trying to prove that tracking is synonymous with quality. Also, tracking to the index means you don't own any cash. So if you have a group of people who come in saying, "I invested my retirement funds in an index fund, expecting that when I needed a can of peas to eat, I could withdraw a portion of my funds, but my portion of the index fund is fully invested." Jack and I used to discuss this in the early days when there wasn't any money in the index fund. What do we do when they're allowed money in an index fund, and everybody wants to make a withdrawal, and there's no money there?

There are a couple of little tricks they can do, but it's a disaster. And so when I see things like today, where there are essentially four programs going on simultaneously on approximately the same subject, I look around and say, Charley, we're awful close to the heat. Should we worry a little bit more? In any event, the thing I worry about is liquidity.

Robin:

I don't get this argument because the same is precisely true for an active fund. Because an active fund will have 2 to 5 percent cash on average, and if millions of people pull their money out at the same time, it'll crash the market. But that is as true for active funds as passive funds. This is the scenario used to scare investors since index funds were invented.

We've had some big tests. We have the dot.com crisis. We had the financial crisis. We had March 2020, which I think people underestimate how big a shock that was to the financial system, and broadly speaking, money in passive funds is stickier than money in active funds.

Charley:

That's the critical point. People involved in indexing are calmer as investors, not as likely to get excited - and certainly not as prone to get excited at the same time. The historical evidence is unbelievably consistent that indexing investors stay in much more than individual stock or individual portfolio investors. This is a false dragon.

Sheila:

It has been just fascinating, and it's also been an enormous privilege to learn from the legends of finance. The world of finance, in some ways, has changed a lot, as we discussed, but in some ways, it hasn't changed. But it's interesting to see. Our heartfelt thanks to all our panelists and the moderator.