WILLIS INVESTMENT COUNSEL
Principled Investing

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TIMELESS PRINCIPLES

Recently, I was going through WIC's archives and ran across the following letter-to-the- editor that was published *in Barron's* 16 years ago. What I wrote then still applies today – perhaps more than ever.

To the Editor:

I've read Burton G. Malkiel's *A Random Walk Down Wall Street* and similar "exposés" and I always get that "what if active management really is worthless" chill.

It is indeed very difficult for active management to overcome all the associated costs and deliver net returns that match, let alone exceed, the S&P 500 index. So why bother? How can I justify charging my clients for what appears to be a futile pursuit? How do I sleep at night?

The condemnation of active management and the advocacy of indexing omit the same crucial factor that the efficient market theory omits: human nature. Delivering above-average returns and beating appropriate benchmarks are certainly important objectives. But for many clients, the opportunity to realize even market returns never materializes because the client fails to stay the course. The client is often his or her own worst enemy. Whether it's the individual who is chasing the latest hot mutual fund or IPO, or the institutional pension fund caught up in a consultant's risk/return scatter graph of last quarter's manager sweepstakes, the powerful forces of human nature insidiously knock investors off course. It's the counseling, the application of discipline, the ability to say no to the crowd and the trust factor that keeps clients invested.

The active-management versus indexing debates focus exclusively on net rate of return. Clearly, over 20 years, an additional 1%-2% of annualized returns can be significant. The 10% "guaranteed" index return is assumed to be superior to the 8.5% active manager's failed strategies. The huge assumption that is not being challenged is that the client will faithfully, unemotionally stay 100% invested in the index over the 20 years. By definition, our index-enlightened client can only reap the "guaranteed" return of the index strategy if he never times the market, never carries any reserve cash, never responds to that sophisticated new strategy all the Wall Street elite are lining up for, never reduces the equity exposure when the board of trustees/investment committee is bearing down and one's job is at risk, never changes to another index strategy to diversify or enhance returns, or ….. Most clients, and indeed many investment advisers, corporate pension officers and consultants simply don't behave that way.

The trusted adviser who has earned the client's respect has the best shot at delivering long-term capital-market returns, which are best achieved by steadfastly staying the course and avoiding capital-loss disasters.

My chill has passed, and I will again sleep well tonight.

Robert T. Willis, CPA, CFA
April 29, 1996

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