Westfield STATE UNIVERSITY

Board of Trustees

Investment Subcommittee

2:00 p.m.
February 2, 2023

President's Boardroom, The Horace Mann Center

A live stream of the meeting for public viewing will also take place on YouTube at the following link: https://www.westfield.ma.edu/live

For information about Westfield State's COVID-19 procedures, visit: www.westfield.ma.edu/covid

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1. Called to Order	Trustee Landrau
2. Minutes	
a. November 15, 2022	Trustee Landrau
3. Items for Information	
a. Fourth Quarter Update and Market Review	CI Eaton Private Wealth
4. Items for Discussion	
a. Active vs. Passive Investment Strategy	Sheridan Carey
b. Investment Subcommittee Charge	Trustee Landrau
5. Items for Action	
a. Motion - Investment Advisor Contract	Trustee Landrau/Stephen Taksar

Attachment(s):

a. Minutes 11-15-22 (Draft)
b. Fourth Quarter Update and Market Review
c. Fourth Quarter Update and Market Review (Statement of Spending Policy)
d. Active vs. Passive Investment Strategy
e. Active vs. Passive Investment Strategy (Common Sense on Mutual Funds)
f. Active vs. Passive Investment Strategy (Great Mutual Fund Trap)
g. Active vs. Passive Investment Strategy (Investors Manifesto)
h. Active vs. Passive Investment Strategy (Unconventional Success)

i. Active vs. Passive Investment Strategy (Burton Malkiel 50 Years Later)
j. Active vs. Passive Investment Strategy (Against the Gods)
k. Investment Subcommittee Charge
l. Motion – Investment Advisor Contract

Westfield STATE UNIVERSITY

BOARD OF TRUSTEES

Investment Subcommittee

November 15, 2022

Minutes

Loughman Living Room, Scanlon Hall

A live stream of the meeting for public viewing also took place on YouTube.

MEMBERS PRESENT: Committee Chair Madeline Landrau

MEMBERS PARTICIPATING REMOTELY: Trustees Paul Boudreau, Theresa Jasmin, and Ali Salehi

Also present from Westfield State University were Mr. Stephen Taksar, Vice President for Administration and Finance and Ms. Lisa Freeman, Associate Vice President for Administration and Finance; and Mr. Robert Quinn from CI Eaton Private Wealth (CI Eaton). Also participating remotely were Mr. Sheridan Carey, Westfield State Foundation Board member, and Mr. Duke Laflamme from CI Eaton.

The meeting was called to order by Committee Chair Landrau at 2:03 PM and it was announced that the meeting was being livestreamed all committee members and guests participating were announced as listed above.

> **MOTION** made by Trustee Salehi, seconded by Trustee Jasmin, to approve the minutes of the July 27, 2022, Investment Subcommittee meeting.
> **ROLL CALL VOTE** passed motion unanimously with Trustees voting in the affirmative: Boudreau, Jasmin, Salehi, and Landrau.

FY23 Third Quarter Update was provided by CI Eaton representatives and the following discussion took place.

- The annualized return was over 2% through June 30 and is higher than that figure now.
- Equities were reduced by 9% to help the portfolio given the challenging market environment.
- The University portfolio declined 14.4% while the benchmark was down approximately 16%.
- The capital preservation number is the original investment plus the inflation calculation from three years ago, plus the inflation calculation for year three. To preserve the purchasing power of the initial investment, a return net of inflation is needed. CI Eaton will project calculations for the next 3-5 years of the total return less the CPI being used as inflation.
- In addition to the goal allocation, CI Eaton will provide the ranges from the Investment Policy for fixed income and equities in their reports. Ranges are currently 30%-40% bonds, 0%-5% cash, and 50%-70% equities.
- The change from 68% to 59% in equities started in December 2021 and non-US equities were reduced in April and September 2022.
- The recent period for bond allocations was beneficial. The upward sloping yield curve was offset by the overweight credit markets.
- There is 70% invested in mid-to-large stocks with a view toward companies having greater earnings than the S&P 500. There is diversity among all sectors except energy. CI Eaton made the decision two years ago

not to invest in fossil fuels, which was going well until the Ukraine invasion.

- The Investment Policy does not limit investments in energy but the University wants to be conscious of Environmental, Social, and Governance (ESG) investing. Trustees stated that since the portfolio provides funds to support University operations, the committee should look into all energy, including sustainable, being mindful of the Carbon Underground 200 list.
- It was requested that CI Eaton provide a recommendation on how and when the committee should invest in more energy, should they decide to. Mr. Quinn stated that is a hard decision as a peace settlement in Ukraine will drive oil prices down overnight. CI Eaton has ownership of Calbert, a pioneer in ESG investing, and receives their research to assist addressing these types of factors.
- Mutual fund holdings significantly outperformed the benchmark so more funds were allocated there.
- After the market bottomed in June, volatility will continue with month-to-month inflation numbers, but CI Eaton will add slightly to equities in the coming year.

<u>FY23 and FY24 Investment Income Withdrawal</u>.

- To assist in developing the FY24 budget model scenarios, CI Eaton developed scenarios of income withdrawals at different values of the portfolio to determine if the planned income distribution of 4% of the previous 12-quarter rolling average was sustainable given the decline in the market.
- The assessments presented will help the University understand what to assume in budget planning. Even with a dramatic decline in the market, $800,000 of interest income should be available for operations to be primarily invested in institutional priorities which support innovation projects and strategies.
- It was agreed that a standing item on the committee meeting agenda will be to review the 4% interest income calculation in the investment policy and request the investment advisors to calculate a similar scenario of income withdrawals to present at each meeting.

Messrs. Laflamme and Quinn left the meeting at 2:56 PM.

<u>Investment Advisor Update</u>.

- Last year the contract with CI Eaton was extended by one year, putting us in the fourth year of a five-year contract.
- Discussion followed, noting the current advisors are meeting the benchmarks and providing comprehensive reports but it was agreed to explore other options, being mindful of the resources needed to do an RFP. [Trustee Jasmin left the meeting at 3:05 PM].
- At the next meeting Mr. Taksar will provide information on other state universities' investment advisors and Mr. Carey will provide information on moving to a passive investment strategy.

<u>Future Meeting Dates</u>.

- February 2, 2023, from 2:00-3:00 PM
- April 20, 2023, from 3:00-4:00 PM
- July 28, 2023, from 10:00-11:00 AM

[Trustee Salehi left meeting at 3:15 PM.]

There being no further business, **MOTION** to adjourn made by Trustee Landrau, seconded by Trustee Boudreau.
ROLL CALL VOTE with Trustees voting in the affirmative: Boudreau and Landrau.

The meeting adjourned at 3:16 PM.

Attachment(s):

- **a.** Draft Minutes of July 27, 2022
- **b.** FY23 Third Quarter Update
- **c.** FY23 Third Quarter Update (Fees)

Secretary's Certificate

I hereby certify that the foregoing is a true and correct copy of the approved minutes of the Westfield State University Board of Trustees Investment Subcommittee meeting held on November 15, 2022.

____ ______________________

Paul Boudreau, Secretary Date

STATEMENT OF SPENDING POLICY

The University has adopted the following spending policy, which will apply to the WSU investment Portfolio.

This Policy seeks an appropriate balance among the following goals:

- Provide current programs with a predictable and stable stream of revenue
- Ensure the real value (defined as purchasing power) of the invested assets and its revenue stream does not decline over the long term

Authorized expenditures during an upcoming fiscal year shall be limited to four percent (4%) of the average total market value of the investment portfolio over a trailing twelve quarter period ending June 30 fiscal year, not to include endowment additions during the current fiscal year. In the event the average annualized total return for the trailing three year period fails to equal or exceed 4 %, then the University shall instead distribute Net Income (defined as interest, dividends and other income receipts from investments less expenses) until such time as the trailing twelve quarter period return equals or exceeds 4%. The amount for the coming year is to be calculated each June 30th and will be reviewed and approved annually by the investment/finance committee.

The annual distributions is being calculated after obtaining 12 consecutive quarters of investment market values. The distribution calculation takes the 12 quarter average and multiplies the average by 4% to arrive at the distribution amount.

STATEMENT OF SPENDING POLICY

The Investment Policy further states:

The Fund is to be invested with the objective of preserving the long-term, real purchasing power of assets while providing a relatively predictable and growing stream of annual distributions in support of the Institution.

For the purpose of making distributions, the Fund shall make use of a total-return-based spending policy, meaning that it will fund distributions from net investment income, net realized capital gains, and proceeds from the sale of investments.

The distribution of Fund assets will be permitted to the extent that such distributions do not exceed a level that would erode the Fund's real assets over time. The Committee will seek to reduce the variability of annual Fund distributions by factoring past spending and Portfolio asset values into its current spending decisions. The Committee will review its spending assumptions annually for the purpose of deciding whether any changes therein necessitate amending the Fund's spending policy, its target asset allocation, or both.

Periodic cash flow, either into or out of the Portfolio, will be used to better align the investment portfolio to the target asset allocation outlined in the asset allocation policy at Section IV. A. herein.

Westfield State University Account History – December 31, 2022

Quarter	MV
20-Mar	$18,468,337.92
20-Jun	$20,206,356.67
20-Sep	$21,136,087.07
20-Dec	$22,957,344.61
21-Mar	$23,537,311.12
21-Jun	$24,740,775.27
21-Sep	$24,544,590.85
21-Dec	$26,051,814.00
22-Mar	$24,248,306.00
22-Jun	$21,917,292.15
22-Sep	$20,936,513.87
22-Dec	$21,826,500.00

Average	**$22,547,602.46**
4% distribution	**$901,904.10**

CI EATON PRIVATE WEALTH

The New York Times

You're the Boss
The Art of Running a Small Business

Active vs. Passive: The Debate Keeps Going

By Jeff Brown August 28, 2009 6:00 am

There's a common refrain whenever the markets are in turmoil: "It's a stock picker's market."

In other words, amid all the confusion, you have to pan carefully to find the nuggets. For investors who favor mutual funds over individual stocks, this view morphs into a case for actively managed funds, which employ teams of stock pickers and analysts, over passively managed indexers that simply try to mirror given market segments.

So, how are the actively managed funds doing against the indexers?

Not too well, although there's enough room for debate to keep the active-management advocates from giving up.

A semiannual study by Standard & Poor's finds that over the five years ended June 30, only 37.1 percent of actively managed funds made up of large-capitalization stocks beat the category's benchmark, the S.&P. 500. Most large-cap investors would have done better with a plain old S.&P. 500 index fund.

Only 26.6 percent of managed mid-cap funds beat their index, the S.&P. 400, while 42.6 percent of managed small-cap funds beat the S.&P. 600.

The study, which looked at 3,500 managed funds, reinforces the findings of many past studies by the S.&P., other firms and academics. Over time, the average active manager simply cannot pick enough market-beating stocks to offset the high cost of running the fund. Most indexers carry expense ratios of less than 0.2 percent, while most managed stock funds charge more than 1 percent, five times as much. Indexers' smaller fees leave more money in the account to compound, making a big difference over the years. (Among bond funds, indexers are hands-down winners, mainly because higher fees can gobble big chunks of bond funds' modest returns.)

Still, the active-management boosters won't cry "uncle," falling back on a variety of arguments.

Lending some support to their view, S.&P. noted that on an "asset-weighted" basis, managed funds matched or beat their benchmarks in "most categories except mid-caps and emerging markets." This analysis takes into account the amount of money investors have in each fund. A few large managed funds that beat the benchmarks can therefore pull up the managed-fund results, even if the average managed fund has trailed the index when assets are not taken into account.

To managed-fund advocates, this means investors are good at picking market-beating funds. But it may also mean that funds with lots of assets can afford to spend money — their investors' money — to lure even more investors.

Marketing on the basis of recent performance can be a dirty trick, drawing investors in too late to share in the big gains. Morningstar, the market-data firm, has worked hard to get insight into this problem, trying to distinguish investor's actual gains and losses from apparent returns indicated by changes in fund share prices — the figures typically used in marketing materials. By looking at cash flows in and out of individual funds, Morningstar has detected a widespread pattern of investors chasing past results, pouring money in after a fund has done well and taking it out after the fund falters.

The average investor therefore does much worse than the investor who buys a block of shares and hangs on through thick and thin. In one example, the investors in the Fairholme Fund, a managed fund which mainly holds large- and mid-cap value stocks, lost 1.68 percent a year over the five years ended July 31, even though the fund officially returned 8.56 percent a year based on share price and cash distributions. An investor who put $10,000 into the fund at the start of the five years would have ended up with $15,078.19. But because many investors bought high and sold low, the average investor would have seen $10,000 shrink to $9,187.75.

Investors who favor managed funds are more susceptible to this kind of self-destructive behavior because fads change fast. The whole idea of using active managers is to hitch your wagon to a hot stock-picking team, and a fund that loads up on a hot market sector — Internet stocks, for instance — can tumble when that sector falls out of favor, driving the active-management investor elsewhere.

Managed-fund advocates often point to pockets of "inefficiencies," dim corners of the market not often visited by analysts and business journalists, where they believe stock pickers can find enough undiscovered gems to beat the benchmarks. Cited most often are funds that invest in obscure small-company stocks and those dealing with hard-to-assess foreign stocks.

Of the funds that invest in United States small-cap value stocks, about 47 percent of those using active management beat their index benchmarks over the five-year period, according to the S.&P. study. That means you have a nearly 50-50 shot at beating the indexers with a managed fund, the best odds for any managed fund category focused on American stocks.

S.&P.'s look at funds containing foreign stocks covered four very broad categories, and generally showed that only a small minority of managed funds beat the benchmarks. Among the emerging-market funds, for example, only a tad over 10 percent beat the index. This ought to be one of the areas where insightful stock picking could pay off. It may be, however, that the high cost of researching emerging-market stocks either chews into returns or discourages the in-depth research that is needed.

Breaking the foreign-stock category down further does reveal some areas where active management pays off, according to a study by FundQuest, a firm that provides market data and analysis to financial-services companies. Over various time periods, for example, 75 to 100 percent of actively managed funds holding foreign small- and mid-cap growth stocks beat the benchmarks, the best performance of the 60 categories FundQuest examined. And 50 to 75 percent of managed funds beat benchmarks in a number of categories: diversified Pacific/Asia, foreign large value, foreign small/mid value, Pacific/Asia not including Japan.

But these small pockets look like exceptions that prove the rule.

And because they would account for only a small portion of the typical investor's portfolio, their market-beating returns would not be very valuable. For most investors, foreign stock funds could make up 10 to 40 percent of a long-term stock and bond portfolio, with the greater amount only for investors who can stomach a lot of risk. But even those investors probably should put most of their foreign-stock allocation into funds specializing in Europe and Japan, since these are the largest foreign stock markets. In those categories, the indexers win.

A final problem with the active-passive debate: It focuses too much on what offers the biggest returns rather than what provides *enough* return. Among the minority of active funds that do beat the indexers, many do so by only small margins. If your long-term plan calls for annual stock returns averaging 7 percent, and you think you can get that with a low-fee S.&P. 500 indexer, is it really worth a lot of trouble to shuffle your money among a sequence of managed funds you expect to return 7.5 or 8 percent? You could, of course, pick funds that have beaten the indexes by bigger margins. But why take on a lot of annoyance and risk hoping for 10 or 12 percent if 7 percent is enough?

In picking any managed fund, you can never be certain that past success was a matter of skill, not luck. And even if you are convinced it was skill, there's always the chance the manager will lose the magic, retire, quit or die. That could force you to find a new fund, perhaps exposing you to a big tax bill when you bail out of the old one.

With an indexer on autopilot, you don't have to worry about who's in charge, and that can make it much easier to sleep at night.

Comments are no longer being accepted.

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REN E. BUFFETT

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COMMON SENSE ON MUTUAL FUNDS

Fully Updated 10th Anniversary Edition

FOREWORD BY DAVID SWENSEN
Chief Investment Officer, Yale University

COMMON SENSE ON MUTUAL FUNDS

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JOHN C. BOGLE

with total assets of $200 billion, had grown from 3 percent of equity fund assets in 1995 to 6.4 percent in 1998. By mid-2009, index fund assets had soared to $460 billion, representing 11 percent of equity fund assets. And cash flow into index funds has been even stronger. While investors liquidated $281 billion of actively managed funds on balance during the past two years, they actually added $50 billion to their index fund holdings.

The returns earned by the S&P 500 Index have also consistently remained superior. Recent data from Morningstar show that a low-cost index fund tracking the S&P 500 would have outpaced a majority of its large-cap peers in six out of the past eight years. Even in those two lagging years, the index fund outpaced 49 percent and 40 percent of peers, a "losing" record that would be the envy of many active managers.

While the current version of Figure 5.1 is not quite as imposing as the version from the first edition, the 50-year margin of 1.4 percent is almost exactly equal to the 1.3 percent advantage that the S&P 500 Index earned when I first examined this comparison for the 30-year period 1946–1975 in preparation for my recommendation to the Vanguard directors that we form the world's first index fund.

Updating Figure 5.1 through 2008, the comparative record of the S&P 500 looks remarkably similar to the first edition's version. With the dark decade just ended, the $346,117 final value of an initial $10,000 investment is barely above the $342,400 reported in the 1999 edition, although the cumulative return of the average fund had declined from $216,900 to $201,513. A $144,604 enhancement in financial value by owning the index fund—fully 14 times the initial investment—would seem to fully justify (and then some!) the choice of the term *triumph*.

Indexing Is a Long-Term Strategy

The success that indexing has enjoyed in recent years has been based in part on recognition that acquiring and holding, at extremely low cost, a broadly diversified portfolio dominated by the large, high-grade stocks that dominate the capitalization weight of the market itself is an intelligent long-term strategy and a highly productive one as well. That success has also been engendered by the remarkable performance of the Standard & Poor's 500 Index over the past five years, during which its margin of advantage over the average U.S. equity mutual fund has been the highest in history.

But it is the long-term merits of the index fund—broad diversification, weightings paralleling those of the stocks that comprise the market, minimal portfolio turnover, and low cost—that commend it to wise investors. Consider these words from perhaps the wisest investor of all, Warren E. Buffett, from the 1996 Annual Report of Berkshire Hathaway Corporation:

> *Most investors, both institutional and individual, will find that the best way to own common stocks is through an index fund that charges minimal fees. Those following this path are sure to beat the net results (after fees and expenses) delivered by the great majority of investment professionals.*

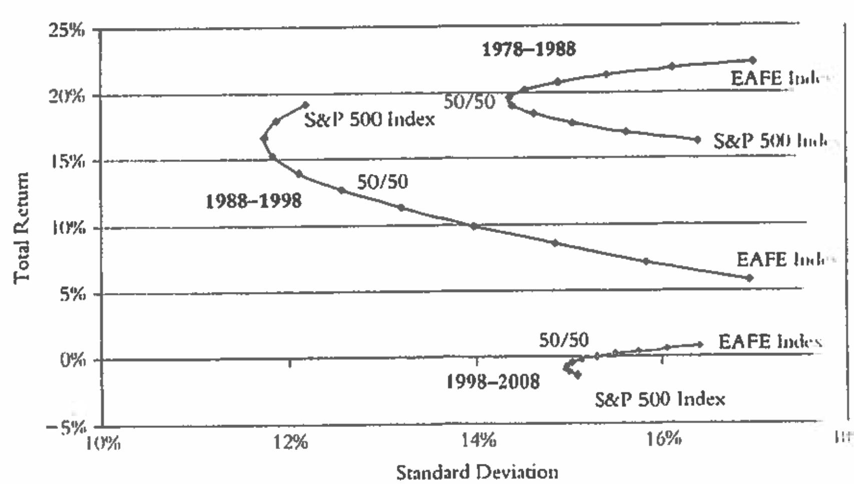
No matter what the future holds, long-term investors who have chosen an index strategy because of its merits are unlikely to be disappointed. On the other hand, short-term investors who have chosen an index strategy simply because they expect a continuation of the highly superior returns demonstrated by the Standard & Poor's 500 Index in the recent past are likely to regret their choice. The historical record makes it clear that the S&P 500 Index has encountered intervals of significant shortfall relative to the average mutual fund. Figure 5.2 shows the percentage of mutual funds outperformed by the S&P 500 Index each year since 1963.

Despite its overall success, there were three periods in which the S&P 500 Index lagged, as reflected in Figure 5.2: 1965–1968, 1977–1980, and 1991–1993. Why? The first period included the "go-go" era of investing, when extremely risky small stocks provided holding 100 percent in U.S. equities. For intelligent investors to allow their entire portfolio strategy to be based on these truly trivial percent differences in risk—really an elusive proxy for risk—seems a wholly unwarranted triumph of process over judgment.

Contrasting the periods ending in 1988 and in June 1998, Figure 8.1 crystallizes two important realities of the global efficient frontier: (1) vast shifts in the frontier may take place over a decade, and (2) variations in risk near the efficient point of each curve are inconsequential despite large variations in asset allocation. Slavish reliance on history seems particularly flawed in markets where currency fluctuations create substantial extra risk.

There is, in the final analysis, only one risk that equity investors need to assume: *market risk*—the inevitable truth that *all* stock portfolios fluctuate in value. For better or worse, most investors choose to assume two additional risks: *style risk*, or choosing mutual funds and stock portfolios with a particular bias, such as those focused on large-cap value stocks, or small-cap growth stocks, or any other stocks whose returns are expected to vary from the total stock market over time; and *manager risk*, or selecting a mutual fund whose portfolio manager may or may not provide the optimal portfolio within the fund's style category.

FIGURE 8.1 Which Efficient Frontier? U.S. versus International Holdings



Leaving aside for the moment the wisdom of assuming those two extra risks—which nearly all investors take for granted—I see no reason for investors to assume yet a third extra risk: *currency risk*. But, to those who, in their own wisdom and judgment, accept the thesis that global investing is necessary, I reaffirm my rule-of-thumb recommendation: Limit international holdings to no more than one-fifth of the equity portfolio.

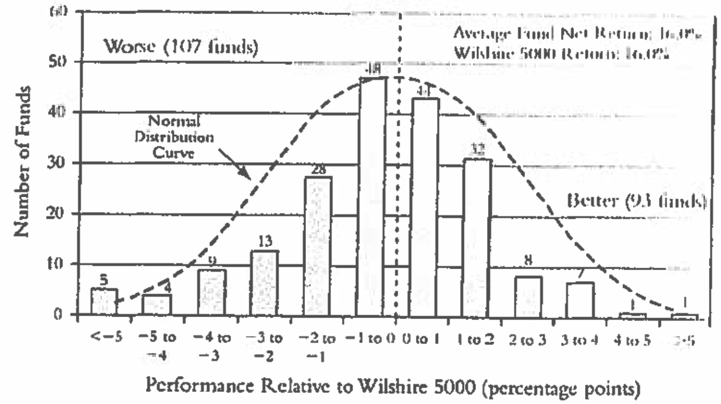
Ten Years Later

The Global Efficient Frontier

As shown in Table 8.2, the essentially zero returns earned in both U.S. and international stocks during the recent decade were a far, far cry from the mostly double-digit returns of the magical—and clearly unrepeatable—preceding two decades. By most measures, however, volatility risks were little changed.

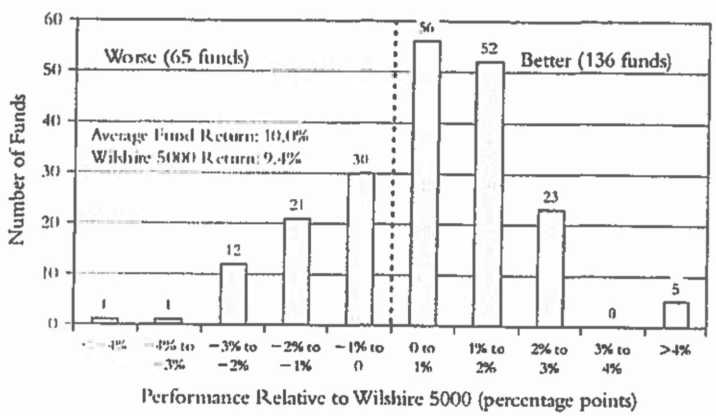
New Figure 8.1 clearly reaffirms my skepticism about relying on the inevitably backward-looking efficient frontier concept to set investment strategy. As I wrote then, "experience leads us to conclude that [the 1998 efficient frontier] is rather unlikely to provide the optimal answer." A glance at the new chart shows that the sweeping variables of the efficient frontier of the 1980s and then the 1990s have been replaced by a cramped arc in which the difference in annual returns between 100 percent U.S. stocks and 100 percent international stocks is trivial. What will the efficient frontier look like a decade hence? A guess: significantly different from its pattern in any of the three past decades. And that is why charting a supposedly efficient frontier, however interesting as an historical artifact, is a weak reed on which to lean.

FIGURE 5.6 Growth and Value Funds versus Wilshire 5000 Index, 15 Years Ended June 30, 1998: Gross Returns (Net Return + Expenses + 50 Basis Points)



TEN YEARS LATER

FIGURE 5.6 General Equity Funds versus Wilshire 5000 Index, 25 Years Ended December 2008: Gross Returns (Net Return + Expenses + 110 Basis Points)



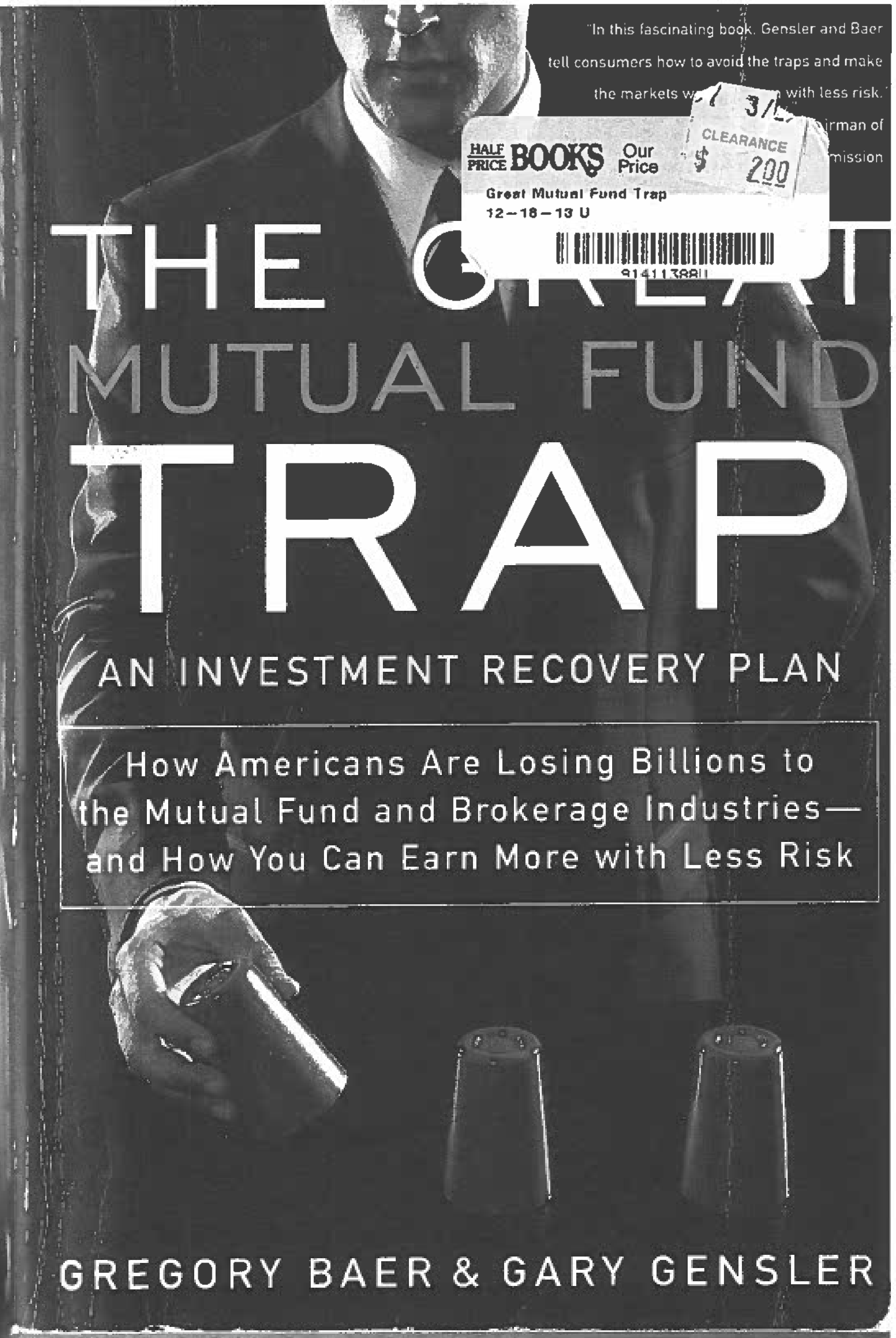
In Figure 5.6, we present the returns of mutual funds *before expenses.* We simply redraw the previous chart and adjust for each fund's expense ratio and estimated transaction costs. In Figure 5.6, the fund distribution shifts to the right. Now, nearly half of the funds (93 of 200) outpace the Wilshire 5000 Index, and 49 do so by one percentage point or more, compared to 107 that fail to match the Index. Still not great odds, but much improved over the after-cost pattern.

When we compare these gross returns with what would be a normal distribution of results—say, based on the random results of a coin flipping contest—something interesting, or even astonishing, happens. When we fit the dotted line in the chart against the funds' gross returns, the result is almost perfect chance—similar to flipping a coin, albeit with the funds demonstrating a somewhat greater likelihood of falling in the middle of the distributions. Yes, one participant in 100 may flip heads 10 times in a row, but 50 participants will flip five heads and five tails. The skill of portfolio managers, then, would appear to be largely a matter of luck, a game of chance. For, as Figure 5.6 shows, relative gross returns of mutual funds have followed a random pattern. For managers in the aggregate, the heavy handicap of cost is simply too heavy to overcome.

TEN YEARS LATER

Indexing and Costs

The lesson remains: The principal reason that the returns of actively managed mutual funds fall short of the returns of the stock market is their costs. This thesis should surprise no one. After all, because of their huge importance in the market—equity mutual funds now own about 24 percent of all stocks—it is almost inevitable that they will provide the same *gross* return as the market. When we look at fund gross returns (by adding back fund expenses and adjusting for sales loads, where applicable), we see a pattern that resembles the random results of a coin-flipping contest, a so-called normal distribution, often known as a "random walk." So it was a decade ago. So it remains today.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GREGORY BAER & GARY GENSLER

by Beat and Gensler

years, you should be distraught, because the overall stock market returned 12 percent over the same period. You took all the risks of stock investing and received a bond-like return.

The Sad Average

As a matter of simple arithmetic, it would not be logical for actively managed mutual funds to beat the market *on average*. It's the old "where all the children are above average" problem again. Thus, no matter how skillful individual managers become, broad market index funds are going to beat about half of them, even before costs.*

Here's how William Sharpe, one of the world's leading financial economists and a Nobel laureate, explains it:

> If "active" and "passive" management styles are defined in sensible ways, it *must* be the case that
>
> 1. before costs, the return on the average actively managed dollar will equal the return on the average passively managed dollar; and
> 2. after costs, the return on the average actively managed dollar will be less than the return on the average passively managed dollar.
>
> These assertions will hold true for *any* time period. Moreover, they depend *only* on the laws of addition, subtraction, multiplication and division. Nothing else is required.[1]

To echo the quotation that started this chapter, that's the raw onion taste in your mouth. Leave it to a Nobel Prize winner to make things simple.

But enough of this cold logic. Let's look at the data and see what happens in practice.

* Actually, to be more accurate, index funds will outperform active managers holding half of the assets. Although this may be a little more or less than half the managers, it will be close.

Things Are Not What They Seem—Survivorship Bias

Before we look at the numbers, we need to pause a moment to consider survivorship bias. Survivorship bias may be a new topic to you, but understanding it is crucial to judging any study on mutual fund performance. We believe it's also crucial to understanding how the fund industry operates and markets itself.

Survivorship bias is the tendency of reported aggregate returns to be biased upward because they exclude funds that went out of business. Funds generally go out of business due to poor performance. Dropping those funds from reported results therefore inflates the returns of the overall mutual fund industry.[2]

Remember the emerging market funds of the early 1990s and the Internet funds of the late 1990s? While those funds were soaring, their results boosted the industry average. Now that many of them have gone out of business, their poor subsequent performance is no longer reflected in industry averages.

Imagine a sales manager at an automobile dealer whose bonus depends on the average sales of all the salespeople employed as of December 31. Think some laggard producers may be fired in December to get the average up? Or imagine that you're anticipating heart surgery and ask prospective surgeons for the five-year history of their patients. They provide histories for only the patients who survived the period. Is that information useful to you?

Alternatively, you can think of this phenomenon as *Survivor*-ship bias, after the recently popular reality show. If someone asked a viewer how interesting the first group of *Survivor* contestants were, they would probably think of the last contestants, Rudy, Richard, Kelly, and Susan, and conclude that it was a pretty wild bunch. They'd probably forget the ones who were voted off in the first few weeks. Remember B.B. and Sonya?

Survivorship bias has a perfectly innocent explanation. When investors are deciding which mutual fund to choose, they want to see a list of their available choices. They don't want to see the records of dead funds, since they can't buy them anyway. As a result, any financial publication giving guidance to investors has good reason to include only live funds in its rankings. That's fair.

What is misleading is when publications (or industry representatives) total up the returns of all those funds and present an *average* return. That's not fair. That number suggests that if you had invested in the average mutual fund over the period being reported, you could have earned the average. Wrong. Now that we're looking retrospectively (examining past performance) rather than prospectively (evaluating choices for future investment), the performance of the least fit is highly relevant. We'd want to know, for example, about the Ameritor Industry Fund, which rather remarkably trailed the S&P 500 Index for eleven consecutive years, from 1989 to 2000. You won't see it in any recent studies, though, because that fund closed up shop in 2001.

The most comprehensive look at survivorship bias was conducted by Burton Malkiel. He found that for the ten-year period 1982–91, the average annual return of *surviving* general equity funds (a survivorship-biased sample) was *17.09* percent. For the same period, the average annual return of *all* general equity funds (including those that failed to survive) was only *15.69* percent.[3]

Thus, over a ten-year period survivorship bias was inflating average industry returns by 1.4 percentage points per year. Over a fifteen-year period, the bias increased (as more dead funds were excluded). Malkiel calculated that survivorship bias inflated returns *2.2* percentage points *per year* when looking at fifteen-year returns.

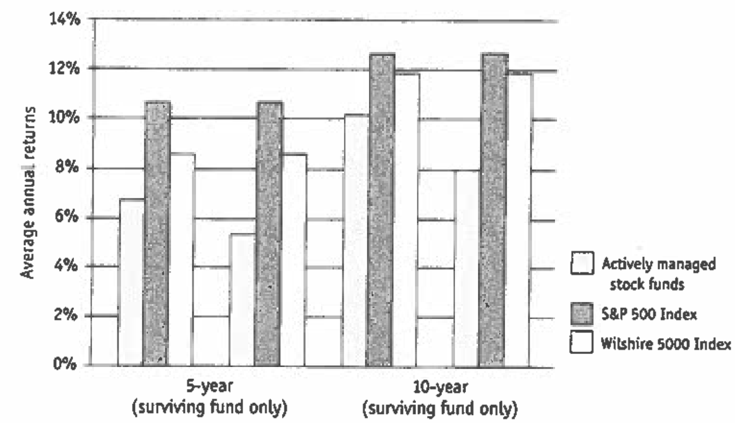
We believe that survivorship bias has probably grown since Malkiel's study. The number of liquidating funds is rising. From 1991 to 1995, the mutual fund industry liquidated 54 funds per year on average. From 1996 to 2000, the industry liquidated 185 funds per year on average, with 225 liquidations in the year 2000 alone.[4] So, in other words, about 4 percent of the funds is disappearing each year. At that rate, just under 20 percent of funds—and their records—should disappear over the next five years.

Thus, unless you're pretty sure that it's been corrected for survivorship bias, take any report about the average returns of mutual funds and mentally deduct about 2 percent per year.

The Average Fund

Here's the grim reality of mutual fund performance: the average stock fund trails far behind the market. Only a small percentage beat the market over a multiyear period. To recap the data we mentioned earlier:

Performance of
Actively Managed Funds Versus the Market



Source: Morningstar Principia Pro, data through September 30, 2001.

Consider these results from the point of view of an individual investor trying to select an actively managed fund that will beat the market (that would be you). The average actively managed fund trails the market considerably. Even an above-average fund only stays even, beating the market by enough to offset its fees and expenses. Only a few funds beat the market by a significant amount, and then not for long. More specifically:

- Over the five-year period ending December 31, 2001, only 33 percent of surviving actively managed stock funds beat the market. Only 25 percent beat it by more than 1 percent per year.
- Over the past ten-year period ending December 31, 2001, only 28 percent of surviving actively managed stock funds beat the S&P 500. Only 11 percent beat it by more than 2 percent per year.[5]

Thus, the recent era not only has failed to erode, but has nicely enhanced the lifetime record of the world's first index fund—now known as Vanguard 500 Index Fund. Let me be specific: at a dinner on September 20, 2006, celebrating the 30th anniversary of the fund's initial public offering, the counsel for the fund's underwriters reported that he had purchased 1,000 shares at the original offering price of $15.00 per share—a $15,000 investment. He proudly announced that the value of his holding that evening (including shares acquired through reinvesting the fund's dividends and distributions over the years) was $461,771. Now, there's a number that requires no comment.*

This cumulative long-term winning record confirms that owning American business through a broadly diversified index fund is not only logical but, to say the least, incredibly productive. Equally important, it is consistent with the age-old principle expressed by Sir William of Occam: instead of joining the crowd of investors who dabble in complex machinations to pick stocks and try to outguess the stock market (two inevitably fruitless tasks for investors in the aggregate), choose the simplest of all solutions—buy and hold the market portfolio.

*Well, maybe one comment. Of the 360 equity mutual funds then in existence, only 211 remain.

Don't Take My Word for It

Hear **David Swensen,** widely respected chief investment officer of the Yale University Endowment Fund. "A minuscule 4 percent of funds produce market-beating after-tax results with a scant 0.6 percent (annual) margin of gain. The 96 percent of funds that fail to meet or beat the Vanguard 500 Index Fund lose by a wealth-destroying margin of 4.8 percent per annum."

The simple index fund solution has been adopted as a cornerstone of investment strategy for many of the nation's pension plans operated by our giant corporations and state and local governments. Indexing is also the predominant strategy for the largest of them all, the retirement plan for federal government employees, the **Federal Thrift Savings Plan** (TSP). The plan has been a remarkable success, and now holds some $173 billion of assets for the benefit of our public servants and members of armed services. All contributions and earnings are tax-deferred until withdrawal, much like the corporate 401(k) thrift plans. (Overcoming what must have been some serious reservations, even the Bush administration determined to follow the TSP model in its plan for Personal Savings Accounts as an optional alternative to our Social Security program.)

(continued)

THE INVESTOR'S MANIFESTO

PREPARING FOR PROSPERITY, ARMAGEDDON, AND EVERYTHING IN BETWEEN

WILLIAM J. BERNSTEIN

FOREWORD BY JONATHAN CLEMENTS

assets from the gullible. Investment companies do not do this.

As AUM increases, the fund benefits from increasing economy of scale. Marketing firms do not pass these per-share savings on to the fund holders by dropping their fees, but rather direct the savings to their bottom lines. Investment companies pass these savings to the fund shareholders with fee reductions.

Marketing firms cherry pick their best funds over the most favorable time periods, producing "mountain charts as steep as the Alps" in their advertising. Investment companies do not.

Marketing firms pay their fund managers according to AUM, not performance. Investment companies do not.

Marketing firms do not educate their clients about investment risks, particularly during long bull markets. The investment company repeatedly does so.[3]

In addition, marketing firms have a nasty habit of self-dealing in their security transactions. Mutual funds pay an enormous amount in commissions and spreads to the brokerage firms that buy and sell securities for their funds. Too often, the fund companies cannot resist the temptation to take kickbacks from the brokerage companies in return for excessive commissions (usually in the form of so-called "soft dollars") or, worse, to direct trades to their own affiliated brokerage arm. Mutual fund investors are almost always unaware of the existence of such shady deals and of how much of their wealth they siphon off.

Unfortunately, unless you are an expert in the field, you will not have access to this sort of information. To make it

simple: The ownership structure of any financial services company ultimately determines just how well it serves its shareholders in the long run. Table 5.1 demonstrates this vividly; out of 18 large fund families, the "nonprofit" and privately owned ones are ranked first, second, third, sixth, and ninth, with fund companies owned by publicly traded parent firms bringing up the rear.

Do not invest with any mutual fund family that is owned by a publicly traded parent company.

Table 5.1 Mutual Fund Performance and Ownership Structure

Rank	Company	Ownership Structure	% of Funds with 4–5 Morningstar Stars	% of Funds with 1–2 Morningstar Stars
1.	Vanguard	Mutual	59%	5%
2.	DFA	Private	57%	7%
3.	TIAA-CREF	Nonprofit	54%	4%
4.	T Rowe Price	Publicly Traded	53%	9%
5.	Janus	Publicly Traded	54%	16%
6.	American	Private	46%	20%
7.	Franklin Temp.	Publicly Traded	31%	22%
8.	Morgan Stanley	Publicly Traded	32%	30%
9.	Fidelity	Private	31%	34%
10.	Barclays	Publicly Traded	27%	31%
11.	AIM Invest	Publicly Traded	20%	34%
12.	Columbia	Publicly Traded	23%	38%
13.	Goldman Sachs	Publicly Traded	15%	55%
14.	Dreyfus	Publicly Traded	12%	53%
15.	MainStay	Publicly Traded	20%	60%
16.	John Hancock	Publicly Traded	17%	60%
17.	ING	Publicly Traded	9%	64%
18.	Putnam	Publicly Traded	4%	62%

Note: the ranking is the combined scoring obtained from the percent of funds with 4–5 stars, and the inverse of the number of funds with 1–2 stars.

Source: John C. Bogle, "A New Order of Things—Bringing Mutuality to the 'Mutual' Fund," speech given at George Washington University Law School, February 19, 2008. Courtesy of John C. Bogle.

successfully pick stocks and mutual funds, or that you are able to time the market.

- ❑ Investors tend to be too susceptible to the emotional impact of the news and to the fear and greed of their neighbors. The better you can tune out this emotional noise, the wealthier you will be. Conversely, if you find yourself owning the same securities as your friends and neighbors, you are likely doing something wrong.
- ❑ Human beings are pattern-seeking primates. Most of what goes on in the financial markets, by contrast, is random noise. Avoid imagining patterns; there usually are none.

Heads I Win, Tails You Lose

- ❑ Stockbrokers service their clients in the same way that Baby Face Nelson serviced banks. The more they charge you in fees and commissions and the more disreputable the products they sell you, the higher their income will be. Most likely, they were attracted to the brokerage business for the same reasons that Mr. Nelson and Willie Sutton were attracted to banks—because it is where the money is. Avoid full-service brokerage houses at all costs.
- ❑ Most mutual funds are not much better; their primary goal is not to invest well, but rather to gather assets. These are two entirely different things. Choose fund companies that are owned by the fund shareholders themselves, or are at least privately owned. Avoid fund companies that are owned by publicly traded parent firms.

Fire When Ready

- ❑ You should live as modestly as you can and save as much as you can for as long as you can. Saving too much is not nearly as harmful as saving too little.

- ❑ Design your overall stock/bond allocation with your age and risk tolerance firmly in mind.
- ❑ Consider tilting toward small and value stocks, since they will likely have higher expected returns than the overall market. Precisely how much you do so depends upon the nature of your employment and your tolerance for temporarily underperforming the market for up to several years.
- ❑ If you need to spend more than 4 percent of your nest egg in retirement per year, seriously consider purchasing an immediate fixed annuity. However, you should delay doing this until after the current economic crisis has passed and the status of issuing insurance companies becomes clearer. In any case, the best "annuity purchase" you can make is to delay beginning Social Security until age 70.
- ❑ Teach your children well; the most important financial bequest you make to your children will not be monetary, but rather their ability to save, invest, and spend prudently.

Finally, never, ever forget Pascal's Wager as it applies to investing: The name of the game is not to get rich, but rather to avoid dying poor. In fact, if you follow the advice in this book, I can guarantee you that you *will not* get fabulously wealthy. Rather, I've striven to simultaneously maximize your chances of a comfortable retirement and minimize your chances of living out your final years in poverty. I know of no more laudable or more worthy investment goal.

Unconventional Success

A Fundamental Approach to Personal Investment

David F. Swensen

Author of the bestselling *Pioneering Portfolio Management*

BUSINESS & ECONOMICS

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"Mutual fund managers and marketers are not going to like David Swensen's thoughtful and intelligently opinionated analysis of their 'colossal failure' resulting from the fund industry's 'systemic exploitation of investors.' Coming from the mind and heart of one of America's most successful and integrity-laden money managers, this is a book that will change the way you think about mutual funds. It's high time for you to follow the elegantly simple advice he presents in this wonderful book."

—John C. Bogle, founder and former CEO, The Vanguard Group

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—Jeremy Grantham, Chairman of GMO

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commissions, and an estimated 0.60 percent to market impact. Total active management costs, amounting to about 2.35 percent, provide a handicap too substantial for all but the most skillful or most fortunate.

Index funds provide a clearly superior alternative. Expense ratios for Vanguard's 500 Index Fund amount to less than one-fifth of the dollar-weighted expense ratio for general equity funds. Security trading commissions for Vanguard's fund total 0.005 percent of assets, representing one-fortieth of the dollar-weighted average. Market impact for Vanguard's 7 percent turnover registers at an estimated level of 90 percent below the market impact of the universe of actively managed equity funds. Low management fees, low commissions, and low turnover give index funds a huge edge.

Yet, not all index funds meet the litmus test of investor suitability. A number of widely known funds suffer from poor structures that lead to excessive turnover, high costs, and low tax efficiency. Careful investors choose broad-based, well-structured index funds.

Tax consequences of trading certainly matter to investors, as more than two-thirds of mutual-fund assets reside in taxable accounts. Taxes clearly matter little to portfolio managers, as excessive levels of turnover result in unpleasantly frequent and indefensibly large distributions of gains to investors. The virtually unrecognized scandal of managing taxable assets as if they were tax deferred receives far too little attention from regulatory authorities and the broader investment community.

From a tax perspective, index funds once again provide a significantly better option. Even though passive replication of a market index falls short of total tax efficiency, the low turnover of an index fund produces after-tax results superior to nearly all actively managed portfolios.

The strong correspondence between the mutual-fund industry's two-decade 2.1 percent annual performance deficit and the year-2002 2.35 percent cost of active management suggests that the mutual-fund industry exhibits no stock-picking skill. As a group, mutual-fund managers earn a gentleman's C for unimpressively average performance. By paying grade-A fees for grade-C performance, mutual-fund investors receive a failing mark.

Investor education represents the only reliable means to address the forbidding mutual-fund landscape. The profit-seeking behavior of the mutual-fund industry places the interests of investors in conflict with the goals of fund management companies. High management fees, bloated pools of assets, and tax-insensitive trading combine to inflict serious damage on investor interests.

The highly visible issues associated with conflicts between principals and agents place the mutual-fund investor at a huge disadvantage. Unfortunately, the story continues with a range of less-transparent forces that further diminish return-generation prospects for mutual-fund investors.

# of Mutual Funds

Mutual funds play an important role as a vehicle for ever-increasing amounts of individual investor savings. In recent decades, the share of household assets invested in mutual funds moved from barely visible to quite substantial. In the critical role of providing retirement income, the shift from defined-benefit plans to defined-contribution plans forces individuals to take increased responsibility for retirement investment decisions, placing mutual funds in an ever-more-significant position in the investment world.

Conventional wisdom dictates that retail investors fare best by entrusting funds to the investment professionals who actively manage mutual funds, instead of trying to compete with far more sophisticated players in creating portfolios of individually selected securities. Proponents of mutual-fund investing hold that by pooling funds with like-minded investors, mutual-fund owners gain access to market-beating investment management that would otherwise be unavailable to small investors. The economies of scale gained by combining thousands of individual accounts benefit all participants.

Unfortunately, the conventional wisdom proves less than wise. Actively managed mutual funds consistently fail to produce superior returns. Pre-tax returns fall short of the market-mimicking, passively managed alternative by a substantial margin. Taxes cause actively managed portfolios to produce even more dismal shortfalls. When taking sales charges into consideration, the failure of actively managed muof the term). Some index fund managers "sample" the market of choice, rather than hold all the securities in market proportions. Some may even charge high enough fees to bring their total costs to equal or exceed those of active managers.

- Second, active managers may not fully represent the "non-passive" component of the market in question. For example, the set of active managers may exclude some active holders of securities within the market (e.g., individual investors). Many empirical analyses consider only "professional" or "institutional" active managers. It is, of course, possible for the average professionally or institutionally actively managed dollar to outperform the average passively managed dollar, after cost. For this to take place, however, the non-institutional, individual investors must be foolish enough to pay the added costs of the institutions' active management via inferior performance. Another example arises when the active managers hold securities from outside the market in question. For example, returns on equity mutual funds with cash holdings are often compared with returns on an all-equity index or index fund. In such comparisons, the funds are generally beaten badly by the index in up markets, but sometimes exceed index performance in down markets. Yet another example arises when the set of active mangers excludes those who have gone out of business during the period in question. Because such managers are likely to have experienced especially poor returns, the resulting "survivorship bias" will tend to produce results that are better than those obtained by the average actively managed dollar.

- Third, and possibly most important in practice, the summary statistics for active managers may not truly represent the performance of the average actively managed *dollar*. To compute the latter, each manager's return should be weighted by the dollars he or she has under management at the beginning of the period. Some comparisons use a simple average of the performance of all managers (large and small); others use the performance of the median active manager. While the results of this kind of comparison are, in principle, unpredictable, certain empirical regularities persist. Perhaps most important, equity fund managers with smaller amounts of money tend to favor stocks with smaller outstanding values. Thus, *de facto*, an equally weighted average of active manager returns has a bias toward smaller-capitalization stocks vis-a-vis the market as a whole. As a result, the "average active manager" tends to be beaten badly in periods when small-capitalization stocks underperform large-capitalization stocks, but may exceed the market's performance in periods when small-capitalization stocks do well. In both cases, of course, the average actively managed *dollar* will underperform the market, net of costs.

To repeat: Properly measured, the average actively managed dollar must underperform the average passively managed dollar, net of costs. Empirical analyses that appear to refute this principle are guilty of improper measurement.

This need not be taken as a counsel of despair. It is perfectly possible for *some* active managers to beat their passive brethren, even after costs. Such managers must, of course, manage a minority share of the actively managed dollars within the market in question. It is also possible for an investor (such as a pension fund) to choose a set of active managers that, collectively, provides a total return better than that of a passive alternative, even after costs. Not all the managers in the set have to beat their passive counterparts, only those managing a majority of the investor's actively managed funds.

THE WALL STREET JOURNAL.

JOURNAL REPORTS: INVESTING MONTHLY

50 Years Later, Burton Malkiel Hasn't Changed Views on Indexing

The author of the classic "A Random Walk Down Wall Street" still believes the markets are very hard for any individual to beat.

By Daniel Akst

Fifty years ago this January, an economist named Burton Malkiel published a book calling for an innovation on behalf of the small investor. "What we need," he wrote, "is a no-load, minimum-management-fee mutual fund that simply buys the hundreds of stocks making up the broad stock-market averages and does no trading from security to security in an attempt to catch the winners."

Hard as it may be to believe, index investments weren't readily available to the average saver in those days. But Dr. Malkiel was convinced that active management couldn't consistently beat passive index investing. And in 1976 Vanguard came out with just the kind of fund he advocated. Today the sum of indexed assets is now in the trillions, and index funds, he reports, "account for more than 40% of the total invested in mutual funds and ETFs."

Dr. Malkiel, 90 years old, still says index investing beats other approaches, and he has half a century of additional data to bolster his case, which he does in a 50th-anniversary edition of the book to be published in January. By now an investing classic, "A Random Walk Down Wall Street" has been updated to cover the many financial innovations (from exchange-traded funds to Ethereum) since it was first published. The book retains its author's trademark blend of erudition and wit—and his insistence that markets really are efficient. The Wall Street Journal spoke with Dr. Malkiel about active vs. passive investing, his lifelong penchant for betting, and the contention of critics that indexing could be socially harmful. The conversation was held via Zoom; an edited transcript follows.

WSJ: Burt, your book recounts some of history's worst investing manias and crashes, suggesting that stock prices are given to mad excesses in both directions. So how can you say the stock market is "efficient"?

DR. MALKIEL: What I mean by efficient is that information gets reflected quite rapidly. It doesn't mean that prices are always right or even sane. The trouble is, nobody knows for sure whether they're too high or too low. Even in some of the worst bubbles, some very smart people said prices made sense. And when Alan Greenspan made his famous "irrational exuberance" speech in 1996, he was years too early. You'd have been better off ignoring him.

The point is, nobody knows. And that leads to what is, I think, the essential part of efficient markets: that there are no arbitrage opportunities, no easy way to make money, without taking on a good deal of risk. The result is that markets become very, very hard for any investor to beat. Only a handful of outliers, like Warren Buffett, have done it consistently, and even they flag sooner or later. It's almost impossible to predict who will succeed going forward. Buffett himself recommends indexing.

WSJ: And you still believe indexing is the best way for people to invest in stocks?

DR. MALKIEL: Oh, without doubt, because it works. Each year about two-thirds of active managers underperform the index, and those who outperform in one year are not the same as those who outperform in the next. S&P does something called Spiva, in which they compare the S&P indexes with active managers. And what it shows is that over a 10-year period, roughly 90% of domestic stock funds, for example, are outperformed by the index.

WSJ: If indexing is so great, how is it that endowments like the one at your own Princeton University use active management and end up capturing huge market gains while avoiding the worst drawdowns?

DR. MALKIEL: First, they learned from David Swensen, who ran Yale's endowment, that you can get paid for illiquidity, and institutions like Princeton have endless time horizons to capture this additional premium. Second, they often do not mark to market these illiquid private investments, which makes their returns look more stable. And third, they have access to rare talents and investments that the rest of us can't touch.

WSJ: You advocate indexing, dollar-cost averaging and diversification, and you make mincemeat of such practices as technical analysis, ESG and "smart beta." You see cryptocurrencies as too risky. Yet you're also an inveterate gambler. Do you buy individual stocks?

DR. MALKIEL: Look I don't think a person who has spent one's academic and professional life working in markets would do this without some kind of gambling instinct. I grew up a poor kid in the Roxbury section of Boston, during the Depression. And I knew the price of General Motors stock as well as Ted Williams's batting average. I've always liked gambling; it's fun. So yes, I buy individual stocks. Do I think that I am making a bigger rate of return than through index funds? I've never calculated it, but probably not. Will I continue to do it? Absolutely. Because it's fun! And I read Barron's and plow through The Wall Street Journal every day, because I enjoy it.

And I do all this knowing that it's not very risky for me because I have a good strong retirement fund from my time at Princeton and my service on corporate boards, and that money is 100% indexed. As long as your core retirement portfolio is indexed, you can play around on the margins without much harm.

WSJ: Let's talk about the social cost of indexing. Indexing succeeds by free-riding on the costly research and price-finding activities of active investors. What if everybody did it? Would we even have a stock market? How would we allocate capital? Doesn't indexing reward mediocrity and excellence equally?

DR. MALKIEL: We don't have too much indexing; we have too much active management. I think the market could function fine with just 2% or 3% of investors being active and making sure that information was reflected properly in prices.

WSJ: Other critics argue that, by giving just a handful of giant money managers major holdings in all our leading companies, ownership will prefer stasis to competition. And then there's also the sheer concentration of power. Charlie Munger recently said of

BlackRock's CEO, "I think the world of Larry Fink, but I'm not sure I want him to be my emperor."

DR. MALKIEL: People have suggested that big indexers would encourage a kind of collusion because they own, say, big stakes in all the airlines rather than just one. But it's not happening yet and seems quite far-fetched. I was on the board of Vanguard for 28 years and never saw any such thing. But I think in the future, there may very well be issues of whether the investment companies should be allowed to vote the shares they control without taking account of the opinions of the ultimate shareholders they are investing for. To some extent, there's too much reliance on the services that tell institutional investors how to vote. I think it's not a big problem yet, but could be as the concentration gets even greater.

Mr. Akst, who prepares the Journal's weekly news quiz, is a writer in New York's Hudson Valley. He can be reached at reports@wsj.com.

Investing Monthly

The Best Places to Get Income in the Bond Market Now

50 Years Later, Burton Malkiel Hasn't Changed Views on Indexing

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How to Use ETFs to Create a Fixed-Income Portfolio

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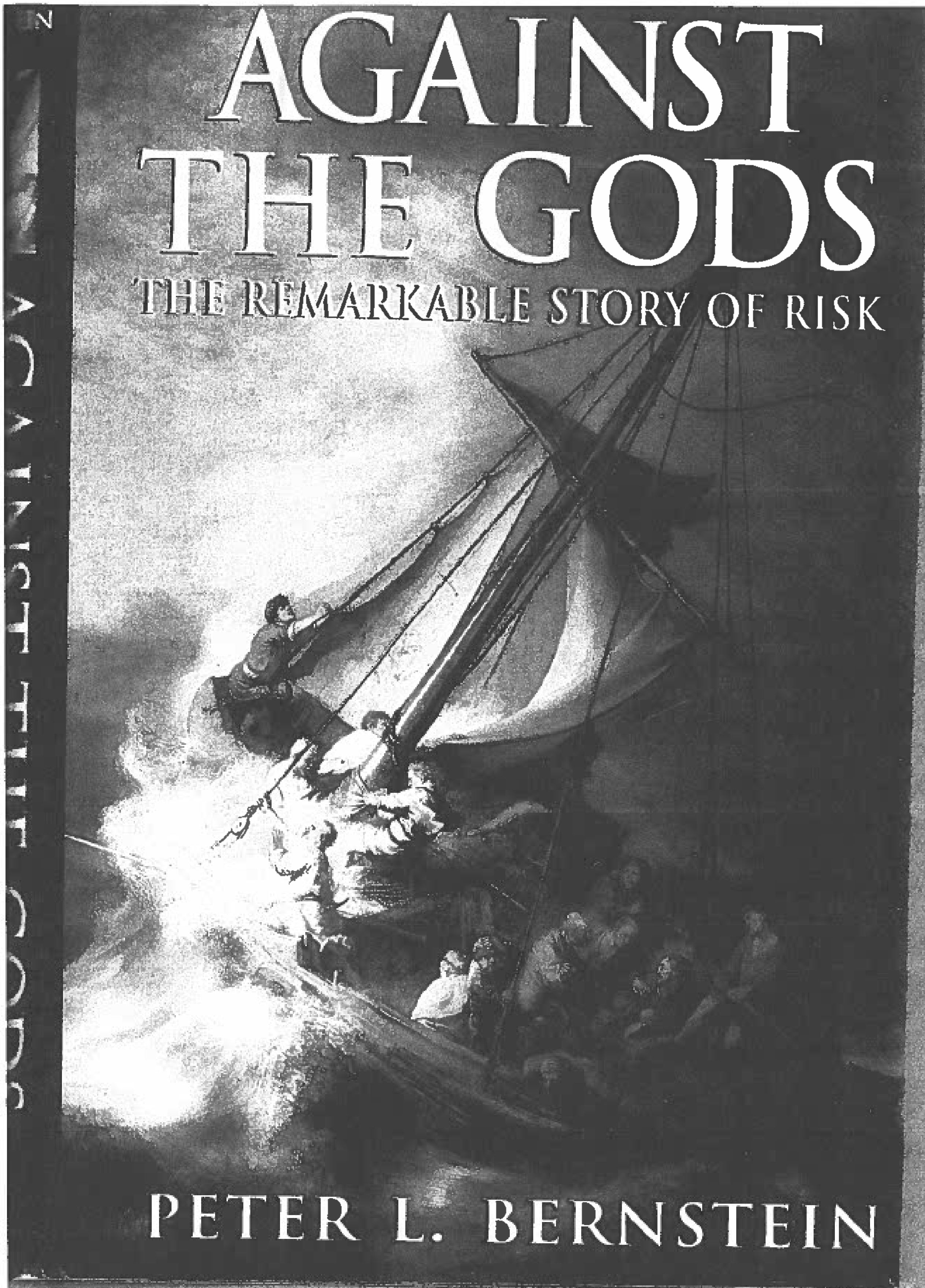
AGAINST
THE GODS
THE REMARKABLE STORY OF RISK
PETER L. BERNSTEIN

or could theories of rational investor decision-making explain them. he endowment effect must be the answer.*

❁

The evidence presented in this chapter gives only a hint of the diliience of the Theory Police in apprehending people in the act of vioating the precepts of rational behavior. The literature on that activity large, growing, and diverse.

Now we come to the greatest anomaly of all. Even though milons of investors would readily plead guilty to acting in defiance of ationality, the market—where it really counts—act *as though* rationality revailed.

What does it mean to say "where it really counts"? And, if that is he case, what are the consequences for managing risk?

Keynes provides a precise definition of what it means to say "where t really counts." In a famous passage in *The General Theory of Employment, Interest and Money*, Keynes describes the stock market as, ". . . so to speak, game of Snap, of Old Maid, of Musical Chairs—a pastime in which he s victor who says *Snap* neither too soon nor too late, who passes the Old Maid to his neighbor before the game is over, who secures a chair for himself when the music stops."[16]

Keynes's metaphor suggests a test to determine whether the market acts as though rationality prevails, where it counts: the prevalence of nonrational behavior should provide endless opportunities for rational investors to say *Snap*, to pass on the Old Maid, or to seize a chair ahead of investors on the run from the Theory Police. If those opportunities do not present themselves, or are too brief to provide an advantage, we might just as well assume that the market is rational even though we recognize that many irrational forces are coursing through it. "Where it counts" means that there are very few opportunities to profit by betting against irrational investors, even though there is so much evidence of their presence in the market. Where it counts, the market's behavior conforms to the rational model.

*This bald assertion should be interpreted broadly. Cross-cultural problems and concerns for the health of the home country add to the value of domestic securities and detract from the value of foreign securities.

If all investors went through the identical rational thinking process, expected returns and adjustments for risk would look the same to everyone in possession of the same information at the same moment. In the unlikely event that a few investors succumbed to nonrational behavior, they would end up buying high and selling low as better-informed investors were driving prices back to a rational valuation. Otherwise, prices would change only when new information became available, and new information arrives in random fashion.

That is how a fully rational market would work. No one could outperform the market as a whole. All opportunities would be exploited. At any level of risk, all investors would earn the same rate of return.

In the real world, investors seem to have great difficulty outperforming one another in any convincing or consistent fashion. Today's hero is often tomorrow's blockhead. Over the long run, active investment managers—investors who purport to be stock-pickers and whose portfolios differ in composition from the market as a whole—seem to lag behind market indexes like the S&P 500 or even broader indexes like the Wilshire 5000 or the Russell 3000. Over the past decade, for example, 78% of all actively managed equity funds underperformed the Vanguard Index 500 mutual fund, which tracks the unmanaged S&P 500 Composite; the data for earlier periods are not as clean, but the S&P has been a consistent winner over long periods of time.

There is nothing new about this pattern. In 1933, Alfred Cowles, a wealthy investor and a brilliant amateur scholar, published a study covering a large number of printed financial services as well as every purchase and sale made over four years by twenty leading fire insurance companies. Cowles concluded that the best of a series of random forecasts made by drawing cards from an appropriate deck was just as good as the best of a series of actual forecasts, and that the results achieved by the insurance companies "could have been achieved through a purely random selection of stocks."[17] Today, with large, sophisticated, and well-informed institutional investors dominating market activity, getting ahead of the market and staying there is far more difficult than it was in the past.

If investors are unable to outguess one another with any degree of reliability, perhaps the computer can capitalize on the market's nonrational behavior; machines are immune from such human flaws as the endowment effect, myopia, and decision regret. So far, computer mod-

Subcommittee Approved: 11-14-18
Board Approved: 12-5-18

Westfield State University
Board of Trustees

Investment Subcommittee Charge
Of Finance and Capital Assets Committee

Introduction:

The Westfield State University Board of Trustees will form a subcommittee of the Finance and Capital Assets Committee to provide investment oversight for university investments. While the university has an investment policy and low risk investments, a more structured and performance focused investment approach is desired which may result in additional resources for the university.

Goal:

To leverage available cash resources, through a prudent investment policy and long-term asset allocation, which yields additional investment income for the university.

Charge:

1. To provide guidance and input in the selection of an investment advisor.

2. Review and update the Westfield State University Investment Policy and authority under the general laws of the Commonwealth of Massachusetts.

3. Review financial performance of the investment portfolio.

4. Utilize best practices to benchmark investment strategies.

5. Provide regular updates to the Finance and Capital Assets Committee and/or the Board of Trustees as is necessary or required.

Westfield
STATE UNIVERSITY

Board of Trustees

February 7, 2023

MOTION

To extend the current investment advisor contract with CI Eaton Private Wealth, formerly known as Eaton Vance WaterOak Advisors and Eaton Vance Investment Counsel, from July 1, 2023, through June 30, 2024.

The current contract with CI Eaton Private Wealth is for three years with the possibility of two, one-year extensions. This would be the second, one-year extension.

The University will develop a request for proposal (RFP) for investment advisor services which will go out to bid in fiscal year 2024 (FY24), based on the Investment Policy that is in place at the time of the bidding process.

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Robert A. Martin, Ph.D., Chair Date