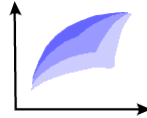


# Efficient Frontier



## An Online Journal of Practical Asset Allocation

Edited by William Bernstein  
and Susan Sharin

**Winter 2005**

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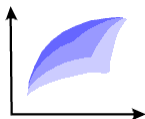
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# Efficient Frontier



William J. Bernstein

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## The \$150 Billion Question

The reelection of George Bush and the strengthening of the Republican congressional majority make the privatization of part of the Social Security system a near-certainty.

Unfortunately, the above sentence contains two of the hottest political buttons in American politics. The word "privatization" evokes emotional responses that cleave this nation's left from its right about as cleanly as any political metric. And Social Security, as we all know, is the original "third rail" of American politics.

I flatter myself that I'm a politically unbiased observer of this issue, since both my Democratic and Republican friends tell me that my views on it are woefully uninformed. So I begin by listing three facts on which all sides can agree:

1. Originally, the system was sold to the public as privatized, but quickly wound up as a social welfare program. Even today, the Social Security Administration mails out individual "account statements," as if each of us had our own separate little brokerage account with them. And yes, to a certain extent, benefits are roughly proportional to "contributions," but there is a strong redistributive element. And the "trust fund," let alone the concept that benefits are paid out of savings, are expensive myths. Social Security is strictly a pass-through system; remove it from the public domain and it becomes easily recognizable as a Ponzi scheme that would take the breath away from even Messrs. Fastow and Ebbers.
2. It follows from #1 above that every dollar of payroll tax diverted into private accounts is necessarily subtracted from the funds normally passed through to current beneficiaries. This money must come from somewhere, and thus far there has been silence on this question from those favoring privatization. The amounts involved stagger the imagination—the total annual inflow into the system is about \$750 billion, so if one-fifth of this is diverted into privatized accounts, we are talking about an immediate shortfall of \$150 billion per year. This cannot be done without raising revenue from elsewhere; the most reasonable proposals involve the establishment of a national sales tax.
3. The issue of just who manages these accounts has not been addressed by its proponents.

Personally, I'd love to see 2% of my payroll taxes funneled into a private account. That's because I'm a money manager; I enjoy running money, and I know how to avoid the sand traps. And the mere fact that you're reading these pages indicates that you're probably in the same boat. But just who manages the accounts of the folks who flip your burgers, provide your tech support, and teach your kids? More importantly, exactly who is their custodian?

The default answers to these questions are, respectively, those inexperienced folks do (the beneficiaries) and the nation's largest financial institutions. If so, this would result in the greatest transfer of wealth the world has seen since the Spanish silver armadas. To understand why, imagine that each year you could skim off a few percent of your neighbor's financial assets. If you were a competent investor, within a very few decades you would become wealthier than him or her. In the very first issue of *Efficient Frontier*, I laid out the logic of this transfer in a piece entitled "[Bequeathing Your Assets to Your Broker](#)." If we are not careful, such a scenario will play out over the entire national financial canvas.

Viewed from the other side of the ledger, toss the following four items into the mix: 3% real returns for stocks, 1% for short-term bonds, a 60/40 portfolio, and 2% to 4% overt and covert expenses from your friendly neighborhood brokerage house or fund company. The result is an after-expenses real return that compares unfavorably to the canned goods in your cellar. Even those of us in the low-expense/multifactor crowd shouldn't be too snide—if we can get an overall 1% portfolio boost from small and value and cover our expenses with skilled rebalancing, the only path to a small fortune is to start out with one. (Remember that while we're peddling as fast as we can, real productivity and wages will be increasing by about 2% per year; thus, the best-case scenario is keeping up with the working Joneses, and just barely at that.)

Of course, the country's wealth would not wind up entirely in the hands of the nation's brokerages and fund companies. As publicly traded entities, some would be distributed to shareholders in the form of dividends and capital gains, but even more would be wasted on obscene management perks and corporate acquisitions that would make the Time Warner-AOL deal look like a tip at the Olive Garden.

The ensuing damage would be twofold. On the economic playing field, large amounts of the nation's capital would be suboptimally employed. The social damage would be far greater, as tens of millions of workers faced retirement with systematically looted private accounts. Even if you and I wound up with bulging private coffers from years of low expenses and multifactor exposure, in the end we'd lose most of it bailing out the system's millions of victims. (Never forget that there will be many more losers than winners, and everyone gets one vote.) Far better to get it right the first time, even if means depriving the greyhounds of wealth and glory.

A grand bargain is called for, which might look something like this: The Left embraces the inevitability of private accounts, in return for which the Right gores the financial-services ox with a uniform and strictly regulated indexed portfolio structure. After retirement, beneficiary assets would then be liquidated

for living expenses as well as exchanged in staggered fashion for inflation-indexed fixed annuities, again, under strict government control.

Privatization can work, and one does not need to be a libertarian to realize the empowering nature of individual accounts. But in order to avoid great slaughter, the sheep will have to be separated from the wolves.

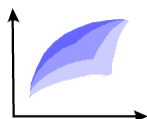


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William J. Bernstein

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## Tastes, Distress, and Jocks

Few concepts in finance are as emotionally challenging to the investing public as the good company/bad stock paradigm. After all, if the purpose of equity ownership is to collect a company's future earning stream, then doesn't it make sense to own the most glamorous, rapidly growing firms?

As readers of these pages know, on average, it most certainly does not make sense. Decades of empirical research using almost any balance-sheet metric you care to shake a CRSP shtick at yield the same monotonous result: value stocks have higher returns than growth stocks. It doesn't matter when—pre-Compustat or post-Compustat—and it doesn't matter where, whether in the U.S., other developed nations, or in emerging markets. While this concept was a tough sell in the late 1990s, anyone arguing against it now will wind up buried under a mountain of affirmative data, to say nothing of recent returns.

The real mystery is no longer *if*, but rather *why*? Behavioralists like Richard Thaler, William Haugen, Josef Lakonishok, and David Dreman believe that the reason is: investors favor growth stocks, thus overpricing them and reducing their expected returns. Conversely, they underprice value stocks, thus increasing their expected returns. In other words, those able to bear the stench of bad companies can belly up for the free lunch.

On the other hand, efficient marketeers, led by Eugene Fama and Kenneth French, posit that value stocks have higher returns because they are riskier and, in particular, point out that value stocks are financially distressed—their balance sheets are so unhealthy that they will blow over in a strong breeze, so investors need to be compensated for this risk.

I've always found the behavioralist explanation more satisfying, particularly the data of Fuller, Huberts, and Levinson (*Journal of Portfolio Management*, Winter 1993), who looked at stocks sorted by price-to-earnings ratio. They found that the top quintile—the most popular growth stocks—increased their earnings by only about 20% *cumulatively* more than the market over the six years following quintile formation. Perhaps the growth stocks were safer, but so much safer that they warranted multiples several times higher than those in the bottom quintile, while yielding an only slightly larger earnings stream?

Taking a different approach, in a recent [working paper](#) John Campbell and his colleagues looked at metrics of market distress and their predictive value, both in terms of subsequent bankruptcy and returns. Without going into all the gory

details, the authors identified several new balance-sheet ratios suggestive of company distress that did a dandy job of predicting future bankruptcy—much better than the traditional techniques (such as Altman’s Z-score and Ohlson’s O-score—you don’t want to know . . . ). The Fama-French risk hypothesis predicts that distressed companies identified by these techniques should have higher returns than the market. Alas, no: The most distressed companies had returns that were much lower than those of the least distressed companies, with multifactor alpha spreads on the order of 20% per year. About the only way an efficient-market enthusiast can wiggle his way out of this one is to posit dimensions of risk beyond company failure—a tall order (or else yell "data mining!" at the top of his lungs).

Even Fama and French have [gotten into the act](#). (Note, the link to the SSRN Web site may require a free registration.) They postulate a world consisting of two types of investors: "A," informed investors, and "D," uninformed investors. (You can guess what the "D" stands for.) The major difference between the two classes is that D investors have "tastes and preferences" for assets that go beyond mere returns, whereas A investors own assets merely based on mean-variance considerations. What kinds of things count as "tastes and preferences?" Glamorous growth stocks top the list of the usual suspects. But there are others: home-country bias and socially responsible investing come easily to mind. Their piece contains no empirical data and certainly concedes no ground to the free-lunch crowd, but rather provides a theoretical framework within which to test behavioral hypotheses.

At this point, I cannot resist tooting my own puny horn. Several years ago, I proposed the "[investment entertainment pricing theory](#)," (INEPT), which postulated that all securities had two return components—a financial return and an entertainment return—and that these two were complementary. That is, a security with high entertainment return tended to have a low investment return, and vice versa. A brief Google search for this model shows only one hit, which is my original piece, so I deduce that it did not gain a lot of traction. But my intent was at least half serious; I think there’s a thesis project in this for anyone who can develop a workable parameter with which to measure investment entertainment value. I would suggest media citations/market cap as a first slap.

My personal favorite among D investor tastes and preferences is the jock factor. American males have a near-pathologic desire to associate themselves with current and retired professional athletes. Even the haughtiest master of the universe will slobber over an NBA point guard, and otherwise sensible grown men regularly pay thousands of dollars to go to baseball camps with septuagenarian shortstops who view their clients with the same amount of respect that table dancers do theirs.

Financial services companies are aware of the jock factor and exploit it to the hilt. One of the most stunning demonstrations showed up in the credits at the end of "Miracle," an excellent film about the victory of the U.S. ice hockey team in the 1980 Winter Olympics. Fully half of the gold-medal winners wound up in the financial services industry, most of them in brokerage. Perhaps there is a previously undescribed high correlation between financial acuity and skill on skates, but somehow one doubts it. Each year, U.S. investors lose

billions in returns for the privilege of associating themselves with the superannuated athletic heroes hired in droves by brokerage houses and insurance companies.

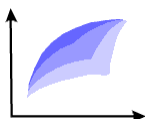
The behavioralists cannot yet be declared the winners of the value-premium debate, but when the two giants of the efficient-market hypothesis openly speculate about investors purchasing consumption goods in the capital markets, that time cannot be very far off.



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William J. Bernstein

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## Link of the Month: Jason Zweig's Web Site

Few financial journalists delight the intelligent investor (pun intended) as regularly as Jason Zweig of *Money*. Now, nearly the entirety of his last decade's oeuvre is available at his new [Web site](#).

Here are some of the best:

- [The neuroscience of investing](#)
- [Jason on Ben Graham](#)
- Classic interviews with [Charles Ellis](#), [Daniel Kahneman](#), and [Peter Bernstein](#) (no relation)

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