

SENIOR CONSULTANT

The Voice of the Investment Management Consultant

Prudent Process: Securities Selection

Thomas M. Roginski

Publisher's Note: At some point in time, we all find ourselves having to explain the complex tasks we perform in terms our mothers would understand. How do we explain the prudent process, securities/manager selection, risk management and/or CAPM theory to our clients who do not have a technical background? I have asked Tom Roginski to address the subject of the prudent process in lay terms. In this first of a three-part series, Tom takes up the topic of how a "prudent man" might select securities for client accounts. Next month, Tom will address client profiling, a prudent approach to risk evaluation, and CAPM theory of the "rational investor" in a time that Tom believes investors are "loss averse" more than "risk averse." Finally, Tom will discuss the tools and techniques necessary to achieve a prudent process of portfolio construction.

Let us start our discussion with a definition of what is required of an investment advisor, meaning someone who renders investment advice for a fee.

The Prudent Man Rule

The fundamental principle for professional money management, as stated by Judge Samuel Putnum in 1830, says: "Those with responsibility to invest money for others should act with prudence, discretion, intelligence and regard for the safety of capital as well as income." Some states which don't have specific legal lists require fiduciaries to uphold the Uniform Prudent Investor Act (UMPIA).

The Prudent Expert Act

A revised version of the Prudent Man Rule is the Prudent Expert Act required by ERISA to guide managers of pension and profit-sharing portfolios. The main addition is that the manager must act as someone with familiarity in matters relating to the management of money, not just prudence.

In the *Financial Analysts Journal* (September/October 1981), it is noted: "The market is an information processing mechanism. That a logical and prudent approach to establishing oneself as being familiar with matters relating to the management of money is to follow the top-down information to knowledge distillation process that is taught in the Chartered Financial Analyst (CFA) program."

In 1520, Machiavelli wrote to Lorenzo Medici the following lines: "I hope it may not be considered presumptuous if a man of low and humble condition dare to discuss and lay down rules for the government of princes, for just as a landscape artist stands in the plains to survey the nature of mountains and hills, and to study the character of the lowlands, takes up his stand on the hills, so, to know well the nature of people one must be a prince and to know the nature of princes one must be of the people."

To draw a parallel between Machiavelli's comments and the securities market, it can be said that if one is to know the nature of the major brokerage houses, one has to have been on what is called the "buy" side, or a member of the community who purchases services from those major brokerage houses. By the same token, to know the buyers of the brokerage house services – the banks, insurance companies, mutual funds and various money managers – one has to have been a member of the brokerage house community. I have been a member of both communities or, to draw another

analogy, I have wandered with the sheep and sat with the shepherds.

It is common practice in the brokerage industry to describe the investment community as a whole – both institutions and individuals – as a herd of sheep wandering in a valley. Around the herd, there are a number of sheep dogs – the salesmen and security analysts from the major brokerage houses. They

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constantly bark at the sheep, trying to drive them in various directions – toward growth stocks, or cyclical industries, or bonds or other investments. And behind the sheep dogs are the shepherds – the portfolio strategists at the major brokerage houses. They tell the sheep dogs how and where to drive the sheep.

Heading the herd of sheep are a number of what might be called lead goats. These are the institutions recognized as leaders in the industry – the big New York City banks or the best known mutual funds. The institutions in the rear of the herd always want to know what the institutions at the front of the herd are doing, and they're always willing to follow. This is why we have cycles in the stock market – the two-tier market, the growth stock mania or, now, the cyclical industry indexation craze. The herd always wants to do what the leaders are doing.

Behind the lead goats, one finds a special class of shepherd – the shepherd who, having knowledge of where the lead goats have gone, expects the sheep to follow. The knowledge of where the lead goats have gone is based on either shorter grass or a lot of droppings on the

ground. In our fundamental interpretation, perhaps uncharitably, the examiner of short grass or goat droppings is the technician.

All this is evolving in a valley surrounded by mountains, and on each mountain peak is an individual we will call a weatherman. The weathermen are leaders of economic opinion – the Milton Friedmans, Paul Samuelsons, George Schultzes and Otto Ecksteins of the world. Their primary chore is to look to the horizon, view the clouds and forecast the weather outlook. The clouds represent Federal Reserve policy, fiscal policy, organized labor activity, international monetary flows, etc. – all those little harbingers of future weather conditions, fair or foul.

Now, the weathermen constantly report their analyses of the clouds to the shepherds; but the shepherds can see the clouds too, and there are times when they decide to act independently of their weathermen's research analysis. When all the weathermen are saying the same thing – that there's rain ahead (higher inflation) or snow (higher taxes) – then the herd anticipates the event because everyone has knowledge of it; this is called "discounting."

When the weathermen cannot agree on what the future holds, the shepherds often act independently. They begin to look at the length of the grass or the corporate earnings that exist right now. We then say that the market "has shrunk its time horizon," and they tell their sheep dogs to drive their particular section of the herd in a certain direction.

When all the sheep start going in different directions, we have a "disruptive market condition." The technicians first say the herd is going one way, then they say it's going another. In our analogy, this is what's happening right now: With no clear consensus on what the economic future holds, the market is discounting a coincident time horizon and not bothering to look out into the future.

Beating the Herd

The average of all the weathermen's forecasts is called "the consensus outlook." For the purposes of our analysis, we track the differences between the high and the low extremes to get a mean, or consensus, outlook. When the difference in the extremes are large, we say that

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the market has a high degree of uncertainty; that is, the weathermen cannot agree. When the difference in the extremes are small, we say that certainty is building in the market and that, in fact, the weathermen are beginning to agree on a forecast. When the weathermen agree, the market moves its time horizon into the future. When they disagree, the market shortens its time horizon.

Besides tracking what the various weathermen, or economic forecasters, are saying, we do our own economic forecast, our own interpretation of how the economic thinking may possibly be wrong. The lefthand part of Figure

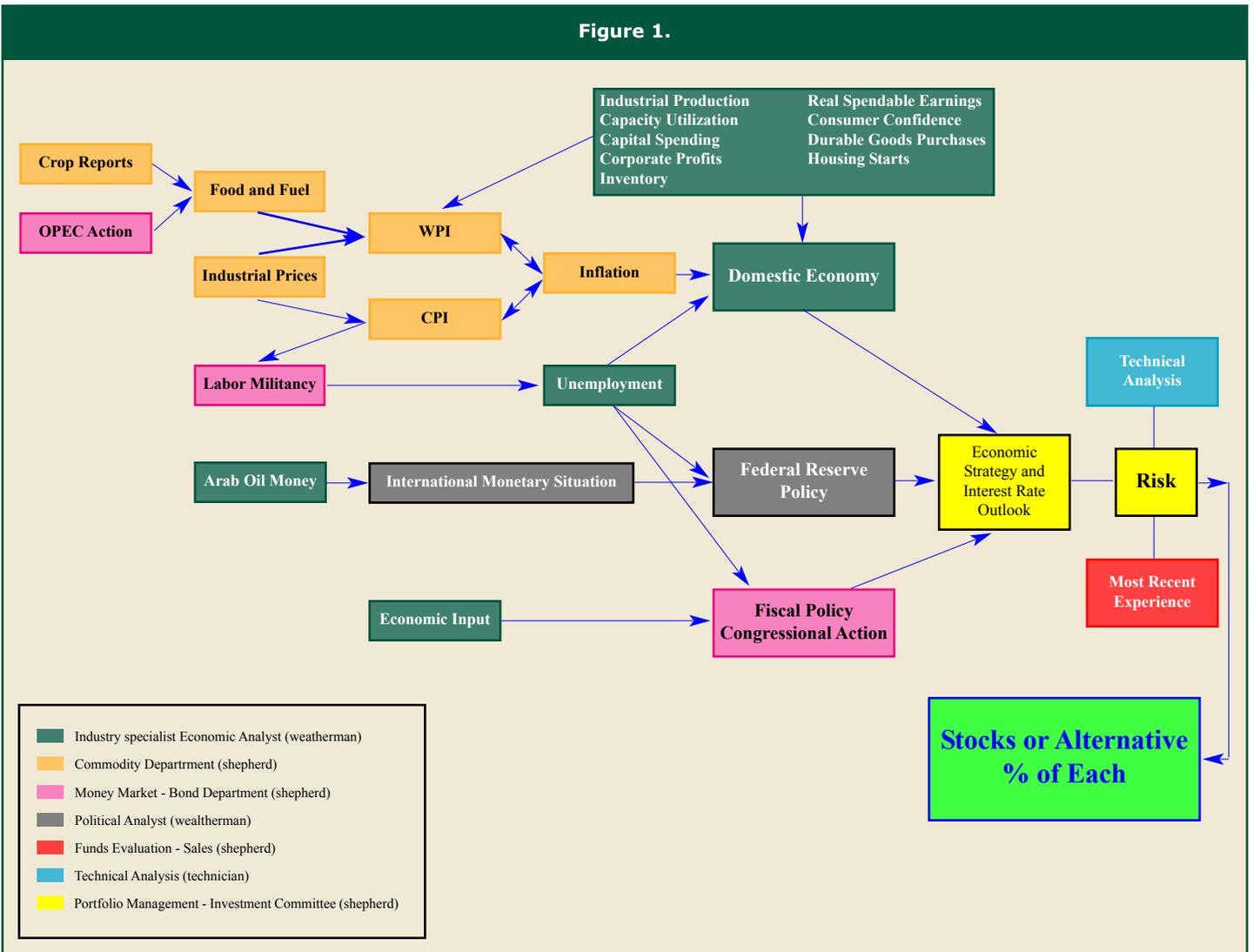
1 shows the clouds on the horizon. In technical language, these are called "exogenous variables." Each of the various economic forecasters must decide, using his own contacts, his own analysis and judgment, what Federal Reserve policy is likely to be and what the various inputs into his forecast are.

Many of our consensus economic forecasters have very elaborate mathematical models that are supposed to take the judgmental aspects out of economic forecasting. But, as the old saying goes, "garbage in, garbage out." Even with the mathematical models, one still has to exercise judgment on

each of the exogenous variables. Once those judgments are made, however, one can derive very precise mathematical definitions of the relationships between variables; these can tell us where the rain is likely to fall and how much of it might fall there.

One of the most important applications of this economic determination is to forecast interest rates. The interest rate forecast is the focal point of economic activity as they represent alternative opportunity costs – the opportunity one forgoes in choosing one asset mix over another. The holding of cash, diamonds, real estate or any other hard asset must be

Figure 1.



defined in terms of what's being given up to hold it.

In judging alternative opportunity costs, the level of risk involved is of prime consideration. The determination of a client's ability to bear risk is one of the most difficult challenges facing an asset manager. One's degree of risk tolerance is a function of both recent experience and level of wealth. If a client – corporate treasurer, bank or individual investor – has recently suffered losses, his ability to tolerate a high degree of risk or to afford a high-risk investment is diminished, even if a high return is offered. In trying to qualify the risk in equity investment, we combine our economic analysis with technical analysis to try to see where the herd is going, before we make initial commitments. The choice between stocks and alternative assets, and the percentage of each that we will put into a portfolio, is the focus of all analysis.

In essence, information flows from the top down. In the information processing procedure, the weathermen's forecast is distilled to all outlook by economic sector, industry or concept. The precise distillation process may differ from firm to firm, but once a consensus is reached concerning the direction opinion leaders will take, the herd will begin to move. If an individual investor arrives at the place toward which the herd is moving more quickly than the rest of the herd, then he can benefit disproportionately from market or herd movement.

In the words of John Maynard Keynes, the stock market – professional investing – is like a beauty contest in which “each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of other judges, all of whom are looking at the contest from the same point of view.” ■

About the Author

Tom Roginski is director of Research and Systems at Transition Management and

Research (TMR), a company he helped to form in 1985. Tom brings to us a unique combination of systems and Wall Street skills. He has been an institutional portfolio strategist at Merrill Lynch, an economist at E.F.Hutton, a financial advisor to the Saudi Arabian Royal Family, a systems advisor to the Getty family and director of research and systems at The Marshall Plan (an institutional, quantitative, money management firm he formed with Greta Marshall who was a former director of the CALPERS pension portfolios).

In June of 1992, Tom worked with Prudential Securities as manager of financial advisor-directed services and headed three departments within Prudential Securities: Portfolio Management, Quantum and Portfolio Advisory Services. In that context he had compliance and revenue responsibility for 862 discretionary money managers. Modeling the behavior of the best money managers at Prudential, Tom began his work that led to PEGASUS (a retail client risk profiling system) and GATEWAY (a suitability testing, order entry and compliance system).

Tom has been a senior member of the New York and Boston Societies of Security Analysts, the National Association of Business Economists, the Market Technicians Association and the Quantitative Analyst Society. He has taught at Baylor University and is currently teaching in the continuing education program of the Boston Analysts Society. His views on investing have been published in the *Financial Analyst Journal* and the *Market Technicians Journal*. His thoughts on technology, have been published by the *Senior Consultant* Newsletter, where he serves as the technology editor. These two systems lay the foundation of the prudent process that TMR markets today. Tom may be contacted via e-mail (TMR@assetmanager.com) or via phone at 978-456-8512.

Notes

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