

Memo to: Oaktree Clients

From: Howard Marks

Re: Returns and How They Get That Way

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"Where do babies come from?" When I was a kid, this was the subject of a great many jokes, and the answer was always the same: "The stork brings them." Now it's fifty years later, and no one jokes about the stork any more. Maybe that's because today's kids learn the real answer so much sooner than we did.

**Where do equity returns come from?** Fewer people ask this question than asked about the stork fifty years ago, . . . and even fewer have the answer. I'll give you one hint: **it's not from the stork.**

### The Source of Equity Returns

In the late 1990s, stock prices exploded upward, along with the number of people buying them. And as long as stock prices rose, the new investors felt they knew all they had to about where equity returns came from: They came from rising prices. And surely you could depend on prices to rise.

What was it that investors thought would cause a given stock's price to rise?

- It's been performing like a rocket.
- It's the subject of a brokerage house recommendation, a TV or magazine story, or some chat room hype.
- Someone (I don't remember who) is recommending it.
- It's selling below an analyst's target price.
- Other people can be counted on to buy it, taking it ever higher.
- In fact, investors have to buy it, because money will keep flowing to stocks and people can't risk omitting this one from their portfolios.
- Or maybe it'll become part of the S&P 500, and indexers and closet indexers will have to add it to their portfolios.

As always, however, the post mortem is more thorough than the simplistic thought process that preceded it, and the results are a lot less pleasant. Dreams of ever-rising prices aren't enough. Now we know there has to be a reason why prices should rise.

Today, cooler heads point out that long-term equity returns are driven by dividends and earnings growth. "Huh?" say the people who entered the market in the late '90s.

I remember having a spirited discussion on this topic with my father in the late 1960s. I came home from the University of Chicago filled with the notion that the value of a share of stock is the present value of its future dividends. "Baloney," my father said, "no one buys stocks for the dividends; they buy them for appreciation." "But what makes them appreciate?" I asked. We never have reached agreement on this matter.

I think we were both right and both wrong. Certainly in a real-world sense, people don't buy stocks for dividends. Dividends provided a small portion of the total return on stocks in the 1960s and far less in the 1990s. Yes, most people buy stocks for appreciation. **But what causes appreciation? There has to be an underlying process at work. We're in trouble if all we can say is "we buy stocks in the hope they'll go up, and they'll go up if new buyers are willing to pay more than the last price."** To explain what'll make the buyers pay more than the last price, we either have to (1) identify what I call an underlying process or (2) fall back on the bromides listed above that led investors off the cliff in the 1990s.

The "underlying process" has to be related to financial parameters. By that I mean the asset values and/or cash flows must be recognized as being worth more than the last price paid. That's what causes appreciation.

Because so few stocks are bought today for asset values, we essentially can disregard them. The vast majority of stocks are bought for the stream of earnings the companies produce.

But how do those earnings affect investors – get through to investors – if not in the form of dividends? That's the question that drove me in the 1960s. It almost verges on metaphysical. If a company has great earnings but those earnings aren't ever paid out in dividends, are they still of value to investors? If it makes a bunch of money but just hoards it, or reinvests it in new products and facilities that generate future earnings that also are not paid out, in what way are its profits of value to investors? That's kind of like the old question, "if a tree falls in the forest but there's no one around to hear it, does it still make noise?"

There are two possible answers:

- Eventually, earnings must be paid out. Common sense tells us that, sooner or later, every company will run out of good reinvestment opportunities, and the cash will then go to dividends, or to stock buy-backs, which have the same effect but better tax treatment. (Of course, the record suggests that when they run out of good reinvestment opportunities, companies often prefer bad reinvestment opportunities to giving the money to the shareholders.)
- Alternatively, if cash builds up in a company and its stock doesn't rise to reflect the buildup but instead languishes "too cheap," someone will bid the stock up in order to take over the company. This is economics at work: the value of every asset is the

present value of the cash flows it will produce in the future, and eventually the market will price the asset to reflect that value, because there are ways to reap it.

### So What Makes Stocks Worth More?

The equation defining the price of a share of stock is a very simple one:

$$P = E \times P/E$$

The price of a share of stock is equal to the earnings per share times the ratio of the stock price to the earnings. On one hand this explains how prices are set, and on the other hand it's just tautological: divide both sides of the equation by E and you get  $P/E = P/E$ . Even I can't argue with that one.

This gives rise to another simple equation:

$$\Delta P = \Delta E + \Delta P/E$$

Change in price is powered by one or more of the following factors:

- increased earnings eventually are turned into increased dividends,
- the undistributed earnings are reinvested to power future earnings growth, and/or
- the likely stream of future earnings comes to be viewed as being worth more than the last price paid, causing an increase in the P/E ratio.

"Growth investors" pursue companies whose earnings are growing the fastest. As per the equation, if the P/E ratio holds, earnings growth will be translated directly into stock price appreciation. And if there's an increase in investor recognition of the company's growth potential, the P/E ratio can expand as well, producing appreciation at a rate that exceeds the rate of earnings growth.

"Value investors," on the other hand, invest primarily in companies where (1) earnings, while perhaps lacking rapid trendline growth potential, are temporarily depressed and likely to rebound, and/or (2) the stock's price is unduly low relative to even the low-growth earnings, and thus the P/E ratio can be expected to expand.

**Any way you slice it, the truth is that changes in a stock's price will be determined by changes in the earnings per share and changes in the multiple at which investors value those earnings.** So those who want to predict the movement of a stock's price, or of the whole market, have to predict those two things. To get to total return, you simply add the dividend yield to the rate of price appreciation.

## The Outlook for Equity Returns

Clearly, equity returns primarily come from price appreciation. And the dominant consideration in long-term appreciation is earnings growth. Why do I say "long term appreciation"? Because even though P/E ratios jump around much more in the short run than do earnings, they tend to move within relatively fixed boundaries and, in the long run, their fluctuations should cancel out.

The simple view – which I tend to take – is that P/E ratios reached ridiculous levels in the 1990s and now, even after significant price declines, still are higher in absolute terms than they were at many previous market **tops**. Thus, you can assume that P/E ratios will stay where they are, and thus that earnings growth will translate into parallel price appreciation. Or you can assume multiple contraction, in which case appreciation will lag earnings gains. But I doubt that a prudent investor can count on P/E ratio expansion as a source of future stock price appreciation. Thus, any positive returns will be determined primarily by the rate of earnings growth.

Over the years I've quoted Warren Buffett as saying something like "people get into trouble when they forget that corporate profits tend to grow at 9% a year." In September I had a chance to ask him if he actually said that. "No," he said, "what I said is 'people get into trouble when they forget that in the long run, stocks won't appreciate faster than the growth in corporate profits.'" Other people spend a lot more time than me studying how fast corporate profits have grown and will grow. However, the evidence I'm familiar with suggests a figure somewhere in mid-single digits.

So with dividends minimal and multiples unlikely to expand (at best), normal historic profit growth seems like a reasonable starting point for equity returns in the long-term future. (Of course, extrapolating historic corporate profit growth implies extrapolating the historic price increases and profit margins. Neither of these is assured, but why go there?) What I'm left with is trendline price appreciation somewhere in mid-single digits. Where in that range, I'll leave to others.

## Adding to Returns Through Active Management

I have written a great deal on the subject of active management (see especially "Safety First . . . But Where?," April 2001) and have no interest in reiterating. But I will discuss the active management industry.

An enormous infrastructure has been built up over the last century for the purpose of beating the stock market. Fifty or seventy-five years ago, that sentence would have read, " . . . for the purpose of managing stock market investments." However, the index fund industry has grown up in the last thirty years and made it clear that average performance can be accessed much more cheaply and dependably through passive management than through active management. Thus the *raison d'être* of the active managers became beating the market.

To do so, the investment management industry invests in analysts, portfolio managers and traders, not to mention accountants, salespeople and risk managers – plus wood paneling, oriental rugs and seascapes. All of this costs money, and the management firms want a return on their spending. So they charge healthy fees. The people whose money the firms manage also bear other costs entailed in active management, such as commissions, market impact, and taxes on short-term gains caused by active trading. The question is, "What are they getting for their money?"

The problem is that there has been no documentation that active equity management consistently provides an edge in the mainstream stock market. Some individuals never beat the market, but even those who do usually see their success limited to brief periods of time. A given strategy works for a while and then stops. It's usually a matter of being patient and waiting until your ship comes in. Very few people are skillful enough to outperform through thick and thin. As I've said before, the attention paid to people like Warren Buffett and Peter Lynch is a tribute to their uniqueness and demonstrates the meaning of the phrase, "it's the exception that proves the rule." The rule is that few people can beat the market for long.

We've already established that equity returns primarily come from appreciation. When seeking appreciation, you can look for one or more of the following:

- 1 increases in an asset's intrinsic value (earnings or asset values),
- 2 movement of the asset's price from a discount toward its intrinsic value (that is, from undervaluation to fair value), and/or
- 3 movement of the price from intrinsic value toward a premium (that is, from fair value to overvaluation).

**In my opinion, superior returns come most dependably from buying things for less than they're worth and benefiting from the movement of price from discount to fair value. Making money this way doesn't require increases in intrinsic value, which are uncertain, or the attainment of prices above intrinsic value, which is irrational.**

The attractiveness of buying something for less than it's worth makes eminent sense. However, doing so requires cooperation from someone who's willing to sell it for less than it's worth. It's the SEC's goal to make sure that everyone has the same corporate information. So how is one to find bargains in efficient markets? You must bring exceptional analytical ability, insight or foresight. But because it's exceptional, few people have it. Once in a while someone will find an undervalued stock or guess right about the direction of the market, but very few people are able to do those things consistently over time.

## So What's To Do?

You can try harder, but everyone's already trying their hardest. Or you can ratchet up the risk level of your portfolio – counting on the long-run relationship between risk and return – but once in a while that'll get you killed. Or you can look for inefficient markets.

In inefficient markets, not everyone has the same access to information. I feel bargains are found most consistently among the things that are not widely known, not understood, or considered to be risky, complex, unfashionable, controversial, or unseemly. When you combine unequal access to information, uneven ability to analyze that information, and the effects of negative biases, it's possible for things to sell for less than they're worth. In inefficient markets, it's possible for a superior investor to consistently identify those bargains, and thus to beat the other players consistently. It's also possible to achieve risk-adjusted returns above those available in other market niches. All it takes is hard work and superior skill.

However, it makes sense to assume that since the greatest reward for active management is found in the inefficient markets (along with incentive fees for the successful managers), that's also where sharp-eyed specialists will focus their efforts. (Think of card counting in blackjack versus betting on the spin of a roulette wheel; where do you think you'll find the Ph.D.s?)

In addition, it must be borne in mind that few sectors remain so inefficient that they can be counted on to provide a free lunch for long. Over the years, many strategies have been thought to represent a sure thing, but most fizzled out. Computer software stocks, the nifty-fifty, oil stocks, emerging markets, and most recently tech-media-telecom – all of these groups have in turn been deified and decimated. Likewise, a number of investment techniques have had their day in the sun and then been eclipsed: covered call writing, portfolio insurance and "market neutral" funds are just a few. **Nothing can be relied on for high risk-adjusted returns just because of what it's called. No investment area has that birthright. It's all a matter of the ability to identify bargain-priced opportunities and implement with skill.**

The bottom line might be that inefficient markets can be the source of superior returns and can be less heavily populated, but the players there are, on average, more competent. Because returns in inefficient markets are more dependent on investors' individual skill (which is highly variable) than they are on the market's overall return, there'll be a greater dispersion of results there. And that means lesser investors should be expected to underperform greater investors by a wide margin.

## Sources of Return for Active Managers

The best way to look at portfolio return ( $y$ ) is as follows:

$$y = \alpha + \beta x$$

In this simple equation,  $\alpha$  is the symbol for alpha,  $\beta$  represents beta, and  $x$  is the return of the market. Alpha is best thought of as a portfolio manager's differential skill or value added. **It is the ability to generate performance unrelated to movement of the market.** Index funds don't aspire to alpha. They're managed by people who know they don't have alpha (actually, most believe no one has any), and they simply strive to reflect the market's movements – no better and no worse. Active managers manage actively because they think they have alpha. They charge for it, and they should be able to demonstrate it. However, many without it seem to have gotten away with charging for it over the years.

Beta is the extent to which a portfolio reflects the return of the market. A portfolio with a beta of 1 and no alpha will move up and down exactly as does the market. A beta of 2 means it will move twice as fast in both directions. A beta of .5 means it'll move half as fast. A beta of zero means a total lack of correlation – the much sought-after "market neutral" fund, where all of the return comes from investor skill. A negative beta means an inverse correlation (a short position on an index fund is the best example).

I believe the alpha/beta model is an excellent way to assess portfolios, portfolio managers, investment strategies and asset allocation schemes. **It's really an organized way to think about the question, "how much of the return comes from what the environment provides, and how much from the manager's value added?"** When one considers these things, some relevant inquiries are:

- Where did the return come from in the past?
- Where is the return expected to come from in the future?
- How exposed is a given strategy (or my overall portfolio) to market movement or dependence on claims of alpha? How much of my future return am I betting on the direction of the market, and how much on manager skill?
- What assumptions am I willing to make about the outlook for those two things?

A lot is written about the tyranny of benchmarks. Excessive benchmarking (and an overemphasis on minimizing tracking error) can force managers to migrate toward benchmark asset weightings in order to reduce their risk of negative performance comparisons. Clearly, if a manager has real skill, this process can suppress it.

However, there are very valid roles for benchmarking. Perhaps the best is in helping to attribute performance between market impact and the manager's value added. In fact, this can't be done without reference to an effective benchmark.

It's obvious that this manager doesn't have any skill:

Period	Benchmark Return	Portfolio Return
1	10	10
2	6	6
3	0	0
4	-10	-10
5	20	20

But neither does this manager (he just moves half as much as the benchmark):

Period	Benchmark Return	Portfolio Return
1	10	5
2	6	3
3	0	0
4	-10	-5
5	20	10

Or this one (he moves twice as much):

Period	Benchmark Return	Portfolio Return
1	10	20
2	6	12
3	0	0
4	-10	-20
5	20	40

This one has a little:

Period	Benchmark Return	Portfolio Return
1	10	11
2	6	8
3	0	-1
4	-10	-9
5	20	21

While this one has a lot:

Period	Benchmark Return	Portfolio Return
1	10	12
2	6	10
3	0	3
4	-10	2
5	20	30

This one has a ton, if you can live with the volatility.

Period	Benchmark Return	Portfolio Return
1	10	25
2	6	20
3	0	-5
4	-10	-20
5	20	25



## Chasing Alpha

There are people who seem able to make money or beat the market year in and year out. It's not certain, however, that they'll manage portfolios long enough to convince the statisticians that alpha exists and that they have it. They might make so much money that they'll stop managing portfolios for others, and thus their performance will cease to be public. Or they might not live long enough for their records to attain statistical significance. (At the University of Chicago they told me it takes 64 years to be sure someone is good rather than lucky; more on this later.) But I know managers, including those I work with every day, who I'm convinced can add to return without adding commensurately to risk – and in fact while reducing risk.

How do these "alpha managers" do it? As I described in "The Realist's Creed," the alpha managers I know come from the "I don't know" school. They don't expect to know more than others about the future direction of economies and markets, and thus they eschew market timing and other forms of macro decision-making. They just try to gain an edge by knowing more than others do about micro matters. As contrarians, they prefer to buy things that are out of favor. They invest defensively, thinking more about what they don't know than about what they do, and worrying more about losing money than about missing winners. They build their records on high batting averages and the absence of losers, rather than on occasional homeruns within a hit-or-miss pattern of returns.

Most of them are hard working and driven. They take their jobs very seriously and think about their portfolios night and day. They tend to talk investments with each other, not football or movies. Many are "early adapters" who use technology to access diverse information sources in order to gain a knowledge advantage. They look for hard asset values or under-appreciated situations. They buy with confidence in their analysis, and if the price of the asset falls, they tend to like it more – and buy rather than sell. **Most important is that intangible something – they just "get it" better than others.**

While going over this list of the characteristics I'd look for in a manager, I want to take a moment for an essential caveat. One thing these criteria guarantee is that there'll be times when investors from the "I don't know" school will look terrible. In times of euphoria, qualities like emphasis on value, contrarianism, skepticism and defensiveness are guaranteed to produce performance that sorely lags the hot sectors and the risk takers. This was amply demonstrated in 1998-99, when the best managers I know watched from the sidelines as others got rich . . . temporarily. People who employ alpha managers might feel pangs of regret over what they pass up in boom times, but they should know the route to performance they've chosen is far more reliable.

Clearly, managers with alpha, **once identified**, can be depended on to a much greater extent than those whose returns are generated primarily by market movements. Having said that, however, I don't want to appear to underestimate the difficulty of finding managers with alpha. I've been on the receiving end of many presentations from managers pursuing foundation business, and I can certify that it's not easy to distinguish

those who sound good and are from those who sound good but aren't. (People who don't sound good usually aren't allowed out to make presentations.)

Certainly the search for alpha managers is a tough one. Not only is it hard to know which managers have it, but:

- The search for them will be littered with mistakes and losses.
- Good managers are likely to close their funds before their limits are exceeded.
- Managers talented enough to exploit inefficiencies will be able to appropriate a fair bit of the excess return for themselves in the form of fees.
- The limited size of inefficient markets and the limited capacity of the managers probably mean very large investment pools can't expect to invest enough with alpha managers to greatly affect their results. And their attempts to pump in large amounts of capital can ruin the opportunity for everyone.

There certainly are stumbling blocks in the search for alpha managers, but it's worth trying. If you aren't satisfied with doing average in efficient markets, what else is there? Invest with managers who claim they know what the future holds and can otherwise out-invest everyone else in the same mainstream stocks? I doubt that's the way. To paraphrase Professor James Lorie of the University of Chicago (circa 1970), I'd rather "index the core of a portfolio and manage the heck out of the periphery" – hopefully with help from managers with alpha.

### The Role of Luck

To end this memo on returns, I want to spend a few pages discussing the part played by randomness (or luck or chance). A new book on this subject is being passed around the alpha manager world more than Playboy was passed around when I was in the ninth grade. It's "Pooled By Randomness" by Nassim Taleb, a Ph. D. hedge fund manager and self-described aesthete.

My "Realist's Creed" list of required ingredients for intelligent investing started with membership in the "I don't know" school; progressed through contrarianism, humility and skepticism; and ended with awareness of prevailing investor psychology. **Taleb's book reminded me of one other essential: being conscious of the role of luck.**

This book can be difficult to read. Here are just two examples:

Popper believed that any idea of Utopia is necessarily closed in the fact that it chokes its own refutations.

... to be technical, these "randomizations" are frequently done during optimization problems, when one needs to perturbate a function.

Nevertheless, I found its contents profound. In "Investment Miscellany" I discussed an article by Richard Bookstaber of Moore Capital and stated that, "What smart people do is put into logical words the thoughts we may have had but never formulated or expressed." Taleb is such an individual. As I did with Bookstaber's article, I will attempt below to communicate and explain some of his salient points, supported by excerpts from the book.

**Randomness (or luck) plays a huge part in life's results, and outcomes that hinge on random events should be viewed as different from those that do not.**

**Thus, when considering whether an investment record is likely to be repeated, it is essential to think about the role of randomness in the manager's results,** and whether the performance resulted from skill or simply being lucky.

\$10 million earned through Russian roulette does not have the same value as \$10 million earned through the diligent and artful practice of dentistry. They are the same, can buy the same goods, except that one's dependence on randomness is greater than the other. To your accountant, though, they would be identical. . . . Yet, deep down, I cannot help but consider them as qualitatively different. (p. 28)

**Every record should be considered in light of the other outcomes – Taleb calls them "alternative histories" – that could have occurred just as easily as the "visible histories" that did.**

Clearly my way of judging matters is probabilistic in nature; it relies on the notion of what could have probably happened. (p.29)

If we have heard of [history's great generals and inventors], it is simply because they took considerable risks, along with thousands of others, and happened to win. They were intelligent, courageous, noble (at times), had the highest possible obtainable culture in their day – but so did thousands of others who live in the musty footnotes of history. (p. 35)

Think about the aggressive backgammon player who can't win without a roll of double sixes. He accepts the cube – doubling the stakes – and then gets his "boxcars." It might have been an unwise bet, with its one-in-36 chance of success, but because it succeeded, everybody considers him brilliant. We should think about how probable it was that something other than double sixes would materialize, and thus how lucky the player was to have won. **This says a lot about his likelihood of winning again.**

As my friend Bruce Newberg says over our backgammon games, "there are probabilities, and then there are outcomes." **The fact that something's improbable doesn't mean it won't happen. And the fact that something happened doesn't mean it wasn't improbable.** (I can't stress this essential point enough.) Every once in a while, someone makes a risky bet on an improbable or uncertain outcome and ends up

**looking like a genius. But we should recognize that it happened because of luck and boldness, not skill.**

In the short run, a great deal of investment success can result from just being in the right place at the right time. I always say the keys to profit are aggressiveness, timing and skill, and if you have enough aggressiveness at the right time, you don't need that much skill. My image is of a blindfolded dart thrower. He heaves it wildly just as someone knocks over the target. His dart finds the bulls-eye and he's proclaimed the champ.

... at a given time in the markets, the most profitable traders are likely to be those that are best fit to the latest cycle. This does not happen too often with dentists or pianists – because of the nature of randomness. (p.74)

The easy way to see this is that in boom times, the highest returns often go to those who take the most risk. That doesn't say anything about their being the best investors.

Warren Buffett's appendix to the fourth revised edition of "The Intelligent Investor" describes a contest in which each of the 225 million Americans starts with \$1 and flips a coin once a day. The people who get it right on day one collect a dollar from those who were wrong and go on to flip again on day two, and so forth. Ten days later, 220,000 people have called it right ten times in a row and won \$1,000. "They may try to be modest, but at cocktail parties they will occasionally admit to attractive members of the opposite sex what their technique is, and what marvelous insights they bring to the field of flipping." After another ten days, we're down to 215 survivors who've been right 20 times in a row and have won \$1 million. They write books on "How I Turned a Dollar into a Million in Twenty Days Working Thirty Seconds a Morning" and sell tickets to seminars. Sound familiar?

**Thus randomness contributes to (or wrecks) investment records to a degree that few people appreciate fully.** As a result, the dangers that lurk in thus-far-successful strategies often are under-rated.

Reality is far more vicious than Russian roulette. First, it delivers the fatal bullet rather infrequently, like a revolver that would have hundreds, even thousands of chambers instead of six. After a few dozen tries, one forgets about the existence of a bullet, under a numbing false sense of security. . . . Second, unlike a well-defined precise game like Russian roulette, where the risks are visible to anyone capable of multiplying and dividing by six, one does not observe the barrel of reality. . . . One is thus capable of unwittingly playing Russian roulette – and calling it by some alternative "low risk" name. (p. 28)

Perhaps a good way to sum up Taleb's views is by excerpting from a table found on page 3 of his book. He lists in the first column a number of things that easily can be mistaken for the things in the second column.

Luck

Skill

Randomness	Determinism
Probability	Certainty
Belief, conjecture	Knowledge, certitude
Theory	Reality
Anecdote, coincidence	Causality, law
Survivorship bias	Market outperformance
Lucky idiot	Skilled investor

The table reminds me of a key difference between the "I know" and "I don't know" schools. "I don't know" investors are acutely conscious of the things in the first column; "I know" investors routinely mistake them for things in the second.

**I think Taleb's dichotomization is sheer brilliance. We all know that when things go right, luck looks like skill. Coincidence looks like causality. A "lucky idiot" looks like a skilled investor.** Of course, knowing that randomness can have this effect doesn't make it easy to distinguish between lucky investors and skillful investors. But we must keep trying.

I find that I agree with essentially all of Taleb's important points.

- **Investors are right (and wrong) all the time for the "wrong reason."** Someone buys a stock because he expects a certain development; it doesn't occur; the market takes the stock up anyway; he looks good (and invariably accepts credit).
- **The correctness of a decision can't be judged from the outcome.** Nevertheless, that's how people assess them. A good decision is one that's optimal at the time it's made, when the future is by definition unknown. **Thus correct decisions are often unsuccessful, and vice versa.**
- **Randomness alone can produce just about any outcome in the short run.** The effect of random events is analogous to the contribution from beta discussed on page six. In portfolios that are allowed to reflect them fully, market movements can easily swamp the skillfulness of the manager (or lack thereof). But certainly market movements cannot be credited to the manager (unless he's the rare timer who's capable of getting it right repeatedly).
- **For these reasons, investors often receive credit they don't deserve.** One good coup can be enough to build a reputation, but clearly a coup can arise out of randomness alone. Few of these "geniuses" are right more than once or twice in a row.
- **Thus it's essential to have a large number of observations – lots of years of data – before judging a given manager's ability.**

\* \* \*

The bottom line for me is as follows:

Equity returns should be expected to average in single digits at best for the next few years. This is because dividends will be moderate and P/E ratio expansion can't be counted on.

Most investors are unlikely to find this market return satisfactory, and thus they will continue to try for more through active management. However, because of the great deal of attention paid to them, most mainstream markets are efficient. This means very few investors there will dependably achieve superior risk-adjusted returns or consistently beat the other market participants.

To be able to earn better risk-adjusted returns and beat the market and the competition, one had better look in less thoroughly explored, inefficient markets. Even there, however, it's essential that one be, or employ, a superior manager possessing "alpha."

**It's hard to separate good managers from not-so-good managers, and to do so it's essential that we identify returns earned through genuine, repeatable skill, not just good fortune. In that regard, records that have been rendered above average by occasional flashes of greatness tell us much less than records that consistently have been even modestly superior over long periods of time, and those that demonstrate a dependable ability to avoid losses in tough markets.**

November 11, 2002