The Case for an Unmanaged Investment Company

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The problem of choice and supervision which originally created a need for investment companies has so mushroomed these institutions that today a case can be made for creating a new investment institution, what we have chosen to call an "unmanaged investment company"—in other words a company dedicated to the task of following a representative average.

At the present time there are over 250 active investment companies in the United States. With a growing proliferation of investment companies—each with different managements and slightly differentiated investment policies—becoming informed about investment policies, equity holdings and past performance can be as painstaking and time-consuming as trying to become informed about the individual enterprises which are indirectly represented. Given so much choice, it does not seem likely that the inexperienced investor or the person who lacks the time and information to supervise his own portfolio will be any better able to choose a better than average portfolio of investment company stocks.

While investing in the Dow Jones Industrial Average, for instance, would mean foregoing the possibility of doing better than the average, it would also mean that the investor would be assured of never doing significantly worse. In addition to the ease with which one could follow the performance of his portfolio, the investor would obtain any psychological benefit of having invested in a representative portion of American business, familiar to investors in general. Provided the average were not too large or too complicated, real economies in supervision could be obtained by eliminating the cost of advisory service.[1]

Rise in Institutional Investing

Since the end of World War II a transformation has been taking place in the equity market. The institutional investor has been assuming a more prominent role. Annual net purchases of equities by institutions, which as of 1940 totaled no more than $100 million, have been estimated to have ranged from $1,830 million to $3,000 million in 1954.[2]

According to a recent compilation by the New York Stock Exchange, estimated holdings of listed stocks by institutional investors at the end of 1958 reached a new peak of $45 billion, or 16.3% of the $276.7 billion market value of all NYSE listed shares.[3]

Of the various institutional investors, the rise of the open-end investment company has perhaps been the most spectacular. While the closed-end investment company is still a sizeable financial institution with over $1 billion in net assets at the end of 1956, net assets of open-end companies, which in 1928 constituted only five per cent of the assets of all management investment companies, were in 1954 valued at over five times the closed-end figure[4]; in 1956 at over seven times the closed-end figure. Table 1 depicts the growth of investment company assets, 1940–57.

If the figures for the New York Stock Exchange listings are representative of the general pattern of equity holdings, one can infer that mutual funds are now the most important institutional investors. Mutual funds and non-insured pension funds—the two largest groups—held $10.2 billion and $9.1 billion of the shares trade on the NYSE at the end of 1958.[5] In a way this is surprising since objective studies indicate that the closed-end investment companies have on the average tended to outperform open-end companies.[6]

The rise in popularity of open-end investment company shares has variously been attributed to a realization that equities are a hedge against inflation, vigorous promotion by investment companies on this ground, a ready willingness of investment companies to redeem outstanding shares at asset value, relaxation of state laws regulating private trust investments, a redistribution of income which permits middle-income people to in-

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Table 1. Growth of Investment Company Assets since 1940, Funded Debt and Bank Loans (millions of dollars)

Year	Open-End	Closed-End	Total
1957	8,714	1,210	9,924
1956	9,046	1,264	10,310
1955	7,838	1,199	9,037
1954	6,109	1,188	7,298
1953	4,146	928	5,675
1952	3,931	978	4,910
1950	2,531	843	3,374
1948	1,506	745	2,250
1946	1,311	851	2,163
1944	882	739	1,621
1942	487	557	1,044
1940	448	613	1,062

Source: National Association of Investment Companies.

vest part of their increased income, and the fact that other institutions in their shift toward equities have favored mutual fund shares.[7]

Whatever the forces responsible for the growth of investment companies are, it appears certain that they are not likely to abate within the foreseeable future. According to Arthur Wiesenberger the growth in the assets of mutual funds (net investment plus capital appreciation) has been remarkably constant for the past 15 years—exceeding 20% a year. Within the next decade, continuation of this trend would result in a business of $40 to $50 billion with more than 5 million shareholders.

Performance Records

While a great deal of information on investment companies has been collected in recent years[8] and analyzed in terms of performance[9] no one has seriously questioned two of the basic axioms of investment company policy: notably, that professional advice and continued supervision are worth their price.

The evidence that can be cited, however, indicates that the average return from professional advice and continued supervision is very low. In many cases it is zero or negative; in other words, investment companies as a whole have not outperformed representative stock averages which could form the basis of an "unmanaged" portfolio.[10] This is not to contend that there haven't been better than average investment companies, but rather that these companies in the main have been offset by other companies which have performed less well than the major averages.

While it seems clear that no single standard will suffice as a measure for comparing the performance of investment companies with different investment policies or goals, and with varying emphasis upon preservation of capital, income, and capital appreciation, a general comparison of investment company performance with leading market averages is valid if one accepts the assumption that the management goal is to outperform the unmanaged average under consideration.[11]

The Cowles Commission's studies[12] and others[13] suggest that stock market forecasters have on the average been unsuccessful at forecasting.[14] Indeed, since to be correct in forecasting a substantial change in price implies that the market has made an error in buying and selling at existing prices, a serious question can be raised as to whether it is reasonable to expect forecasting to ever be successful on the average. On the basis of both logic and the experience of forecasters one has reason to doubt that the performance of the average investment companies would be better than the performance of representative averages. At least three important sources of information can be cited as confirming this doubt.

(1) The Securities and Exchange Commission once undertook to test claims of investment companies and their sponsors that these organizations provide the investor with a kind of specialized and expert management which he was not qualified to undertake himself or could not individually afford to get.[15] Investment company results were compared with performance of a common stock index over the years 1927–1937, which included years of rising and declining prices and active and inactive security markets. The conclusion of the Commission was that over this period no significant difference existed between the performance of investment companies and that of the common stock index.

The performance of investment companies was slightly poorer than the index during years of rising prices and better than the index during periods of declining stock prices. "As the performance of these investment companies was substantially that of a common stock index—which may be regarded essentially as an unmanaged portfolio—it appears that the typical investment company over the past decade failed to meet the sometimes avowed objective of a performance surpassing such an index."[16]

(2) The American Institute for Economic Research has compared the performance of a large number of leading investment companies with Moody's 125 stock average during the period

1920–1958. Both averages are adjusted to show annual reinvestment of dividends. Of interest is the fact that over this long period of time the two averages parallel each other closely.[17] It does not appear that the performance of investment company stocks has been superior to the representative average.

(3) An inspection of Arthur Wiesenberger's data reveals that for the period 1947–1956, only 11 of 89 leading diversified common stock and balanced funds had a percentage increase in net assets per share (plus dividends and distributions) in excess of the percentage increase in the DJI (255%) which makes no allowance for dividends.[18] It is clear that over the time period considered an investor would have been better off on the average to have invested in a company following the DJI than to have picked an investment company at random.

IMPLICATIONS AND PROBLEMS

While nearly any reputable market average could form the basis of an unmanaged investment company, the most likely candidate is the Dow Jones Industrial Average. This judgment is made not because the DJI Average is a particularly good index, but because it is familiar to nearly every investor; it is an average which, whether it deserves it or not, has the veneration and respect of its well known component parts—General Motors, Standard Oil (New Jersey), AT&T, etc., all rolled into one. On that basis it could be sold on faith alone, for what investor would not like to own a share of the DJI, a share in American enterprise itself?

For our purpose it will be useful to discuss the idea of an unmanaged investment company in terms of the DJI Average since it brings to light some of the problems and pitfalls that would beset unmanaged investment companies.

Each of the 30 components of the DJI, which include 29 industrials and one utility, is a relatively high-grade stock with a broad investment following. In 1953, DJI stocks represented 15 different industries and had a market value equal to about 31% of the value of all stocks listed on the New York Stock Exchange. They had a pre-tax income in 1951 estimated at about 18% of the value of all corporate profits before taxes. The aggregate volume of trading on the New York Stock Exchange in the 30 stocks comprising the DJI fluctuated from 7.6 to 19.1% of the total industrial shares traded—based on a 45 day sample taken during 1952–53.[19]

While the DJI represents a significant part of U. S. business, the relative importance of any one of the 30 companies making up the index depends upon the price of an individual share and not on the aggregate market value of the company's stock; in this respect the DJI is similar to the New York Times and New York Herald-Tribune indexes, and differs from those of Standard and Poor. From a technical point of view the DJI cannot claim to truly represent the changing fortune of either business in general or the companies it represents.[20]

Its virtue from a computational standpoint is simplicity. From the standpoint of an unmanaged investment company, it is really the over-simplicity of DJI's construction which makes it a complex index to follow. Rather than increase the number of shares composing the index when a component company decides upon a stock split, the members of the DJI settled upon the ingenious device of lowering the index's divisor (the original divisor was 30, at present it is 4.283) in order to keep the index at its former level. The effect of this adjustment to preserve the index's continuity is to arbitrarily change the weight or importance of the individual components every time there is a stock split. From the standpoint of an unmanaged investment company, following the DJI, this would mean selling a portion of the split shares and buying un-split shares to even up the numerical holdings of each company's stock.

'Everything in Moderation'

Since the decision to split is a reflection of company growth (superior performance rather than inferior performance), one could question at this juncture whether it would be in the best interest of the stock holders of an unmanaged investment company to continue to follow meticulously the DJI. Aside from the brokerage fees involved in shifting the investment company's assets, there would exist the possibility that a sizable shift might in itself affect the relative market price at which shares could be traded. Prudence would seem to dictate that the unmanaged investment company strive only to approximate the holdings suggested by the index and that substantial adjustments be made gradually.

The effect of stock splits on the DJI serves to emphasize one particular kind of adjustment problem associated with the construction of major averages and its possible ramifications with respect to the operation of an unmanaged investment company; the need for and affect of various other adjustments are competently dealt with in

Common Stock Indexes.[21] Suffice to point out here that if the idea of the unmanaged investment company were to blossom into an important financial institution, there would exist a justification for public regulations with respect to the construction of the various indexes[22] and the substitution of component companies to insure stock market stability and the prevention of unfair manipulations.

A few words can be said with respect to the problem of choosing an index to follow. Other things equal, the cost of making the adjustments implied by various stock market indexes is the deciding factor. Popularity and relative performance over selected periods of time would be two additional variables to look at in selecting an index. If the idea of an unmanaged investment company were really to catch fire, there would exist a justification for creating some new indexes. In this connection, indexes subject to what Frederick Macaulay has termed "mathematical drift" bear more careful attention than has previously been given to them.[23]

CONCLUDING REMARKS

According to Weissman, "Both the Gibson and Wendt studies tend strongly to support the view that most investors would be happy if the results obtained by them approximated the stock market average. I am sure that an extensive study would confirm this view, especially for smaller investors and those who attempt to make the most of intermediary movements."[24]

The evidence presented in this paper supports the view that the average investor in investment companies would be better off if a representative market average were followed. The perplexing question that must be raised is why has the unmanaged investment company not come into being? Is it because the average investor is captivated with the notion that a managed fund might conceivably do better than the market average? Is it because the promoters of investment companies are would-be managers? Is it because the public places a great deal of faith in "management"? These are the questions that are uppermost in the authors' minds, the questions we would like to have answered but have no answer for.

The case for an "unmanaged" investment company will have served its purpose if attention has been focused on the costs and returns from portfolio management. In the long-run, both the investor and investor advisory service will be made better off if explicit consideration is given to the relative performance of managed and unmanaged funds; it would serve to make the reward that may be obtained for good management greater and the penalty that is paid for bad management more evident.

It is our belief that the competition of an "unmanaged" portfolio, whether it comes about via the creation of a new kind of investment institution, or a modification of the investment policies of existing institutions, might serve to further this desirable social end.

FOOTNOTES

1. Operating and advisory expenses typically amount to 12–15% of investment income. In 1946 the ratio of expenses to average net assets for the larger open-end funds ranged from .31% for Broad Street Investing Co. to 1.54% for Equity Fund.
2. *Factors Affecting the Buying and Selling of Equity Securities*, Hearings before the Committee on Banking and Currency, U.S. Senate, 84th Congress, 1st Session, (Washington, D.C.: Government Printing Office, March 3, 1955):97.
3. See *Brookmire Investment Reports* (May 11, 1959):456.
4. W.B. Neenan, "Review of Institutional Activity in the Equity Market, 1951–54," *The Journal of Finance*, vol. 12 (December 1957):475–76.
5. See *Brookmire*, p. 456.
6. See C.R. Doane and E.J. Hills, *Investment Trusts and Funds* (Great Barrington, Mass.: American Institute for Economic Research, 1958):72: "The preceding table and chart provide unmistakable evidence that the closed-end companies, both individually and as a group, have provided the more favorable investment results in the past. Moreover, this differential becomes markedly greater when viewed from the standpoint of the results that an investor would have obtained if he had purchased shares at the beginning and sold them at the end of any of the periods shown."
7. Neenan, "Review of Institutional Activity in the Equity Market," p. 476.
8. For the most current and up-to-date information, see Wiesenberger, Arthur & Co., *Investment Companies* (New York: Wiesenberger, Arthur & Co.).
9. For a discussion of some of the problems involved in making comparisons, see R.L. Weissman, *The Investment Company and the Investor* (New York: Harper & Brothers, 1951):95–105. For a recent attempt at ranking companies by performance, see Barnes, *Your Buying Guide to Mutual Funds and Investment Companies* (Larchmont, New York: American Research Council, 1956).
10. Unmanaged in this sense does not mean to imply that the portfolio will be unmanaged but rather that the cost of management will be largely shifted to those individuals responsible for constructing and maintaining the represen-

tative averages. The Dow Jones Industrial Average which originally consisted of 12 stocks "was broadened in 1916 to include 20 and again in 1928 to the present number of 30 stocks, and over the following years numerous substitutions were made in the components of the average." See H.L. Butler, Jr., and M.G. Decker, "A Security Check on the Dow Jones Industrial Average," *The Analysts Journal* (February 1953):37–45, especially at p. 37 for quoted material.

11. Varying emphasis, of course, could be placed upon outperforming the average on the market upside as opposed to the market downside.
12. A. Cowles, "Can Stock Market Forecasters Forecast," *Econometrica*, vol. 1 (1933):309–24. It should be noted that the Cowles studies have been criticized on the grounds that they did not draw any sharp line of distinction between long and short term forecasting or between differing objectives of various forecasters. For a critique of these matters, see D.H. Kerchner, "Some Limitations Upon the Usefulness of Investors' Services," University of Chicago School of Business Unpublished Ph.D. Dissertation (August 1936): 124–36.
13. E.F. Underwood and M.C. Nelkin, "Brokerage House Opinion at Turning Points in the Stock Market," *The Analysts Journal* (4th Quarter, 1946).
14. Not all of the studies are negative. An unpublished study by Erwin Goehring covering the period 1921–33 suggests that some of the larger professional forecasting services were right more often than wrong in predicting the trend in the general market. See E. Goehring, "An Appraisal of Some Security Price Forecasting Services," University of Chicago School of Business Unpublished Masters Thesis (March 1938).
15. See R.L. Weissman, *The Investment Company and the Investor*, p. 96.
16. Weissman, p. 96.
17. Doane and Hills, *Investment Trusts and Funds*, p. 67.
18. Wiesenberger, Arthur & Co., *Investment Companies*, pp. 129–31.
19. These figures are from Butler and Decker, "A Security Check on the Dow Jones Industrial Average," pp. 37–39.
20. See S.A. Smerling, "Found a Realistic Market Measure," *The Analysts Journal* (May 1957):59–62.
21. Alfred Cowles 3rd and Associates, *Common Stock Indexes, 1917–1937* (Bloomington, Indiana: Principia Press, Inc., 1938):1–50.
22. The stock-split adjustment problem in the DJI, for instance, could easily be corrected for by adjusting the numerator of the index rather than the denominator to preserve the continuity.
23. F.R. Macaulay, *The Movements of Interest Rates, Bond Yields and Stock Prices in the United States Since 1856* (New York: National Bureau of Economic Research, 1938):147–48.
24. See Weissman, *The Investment Company and the Investor*, p. 97.