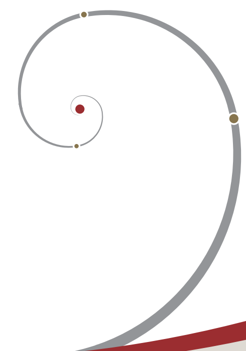
A reprinted article from Volume 8, Number 2, Summer 2007

THE JOURNAL OF
Investment Consulting

A Conversation with Peter Bernstein



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In 2000, the *Boston Globe* called Peter L. Bernstein "America's greatest living economic journalist." As the first editor of the *Journal of Portfolio Management* and the author of nine books on economics and finance, Mr. Bernstein possesses credentials for the title. The roles of journalist and author, however, make up a small part of a résumé that spans more than 65 years.

Mr. Bernstein earned a degree in economics *magna cum laude* and was elected to Phi Beta Kappa at Harvard University. He began his career in 1941 as a researcher at the Federal Reserve Bank of New York. During World War II, after working as a civilian in the Office of Strategic Services (OSS) in Washington, DC, he joined the U.S. military and was assigned to OSS operations in Europe. In 1951, he joined Bernstein-Macaulay Inc. as chief executive officer, where he personally managed individual and institutional portfolios. Since 1973, he has been president of Peter L. Bernstein, Inc., an economic consultant to institutional investors and corporations and publisher of the newsletter *Economics and Portfolio Strategy.* He helped launch the *Journal of Portfolio Management* in 1974 and continues to serve as its consulting editor. He also has served as an instructor in economics at Williams College in Massachusetts and an adjunct professor at the New School for Social Research in New York City. His many honors include the Award for Professional Excellence, the Association for Investment Management and Research's highest honor; the Graham & Dodd Award, given annually for the outstanding article published in the *Financial Analysts Journal*; and the James R. Vertin Award, which recognizes individuals who have produced research notable for its relevance to investment professionals.

Among Mr. Bernstein's best-known books are *Against the Gods* (1996), an award-winning history of risk management; and *Capital Ideas: The Improbable Origins of Modern Wall Street* (1992), a guide to the development and application of modern theories of finance and investing. In 2005, his book, *Wedding of the Waters: The Erie Canal and the Making of a Great Nation,* won the John Lyman Award from the North American Society for Maritime History for the best book on U.S. maritime history. Mr. Bernstein also has written numerous articles for professional journals such as *The Harvard Business Review* and the *Financial Analysts Journal* as well as the popular press, including the *New York Times,* the *Wall Street Journal, Worth* magazine, and Bloomberg publications. His most recent book, *Capital Ideas Evolving,* was published in the spring of 2007.

In September 2006, Mr. Bernstein spoke with members of the *Journal of Investment Consulting*'s Editorial Advisory Board about his achievements and mistakes, the importance of understanding the inevitability of surprise, and the real-world application of investment theory by some of the best-known names in economics during the past 50 years. Joining in the discussion were Edward Baker III, the *Journal*'s editor-in-chief, The Cambridge Strategy, London and San Francisco; Mark Anson of Nuveen Investments, Chicago; Roger Edelen of Boston College, Boston; Ronald Kahn of Barclays Global Investors, San Francisco; Tony Kao of General Motors Investment Management, New York; and Meir Statman of Santa Clara University, California. This interview is the sixth in the *Journal*'s Masters Series, which presents topical discussions with leading experts and visionaries in finance, economics, and investments.

A CONVERSATION WITH PETER BERNSTEIN

Ed Baker: We appreciate having you with us today, Peter. Perhaps you could start by giving us some background on the major factors that influenced your views and helped to shape your career.

Peter Bernstein: First of all, I was fortunate to study economics at Harvard in the late 1930s, when the faculty was trying to learn the theories of Keynes[1] at the same time they were teaching them to us. That was an

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enormous intellectual experience. Growing up during the Depression also influenced my views. Even though that's now a long time ago, it's still there as an influence. The main thing that experience taught me was a sense of humility and an awareness of the importance of surprise, that is, unexpected things happen. Next, and I say this with some humility, I've tried terribly hard to keep my integrity, control my ambition, and put clients first. I've been serious about that from the beginning. Finally, I've been blessed with more than 60 years of marriage. I was widowed, and Barbara is my second wife. I've had wonderful companionship that has been a major influence on my success. I couldn't have done it any other way.

Ed Baker: We also wanted to ask you what you consider your major achievement. Maybe there is more than one, but if you had to pick one achievement, what would it be?

Peter Bernstein: The greatest joy I've had has to be the books that I've authored. This includes one that came out in the 1960s that nobody knows anymore called *A Primer on Money, Banking, and Gold,* which was in many ways a precursor to much of what I wrote later. These books are not only my greatest joy, but I'm still hearing from people around the world who have read them, so I guess you'd have to say they are also my greatest success.

Ed Baker: I wanted to mention that I used this interview as motivation to go back and read your 1992 book, *Capital Ideas: The Improbable Origins of Modern Wall Street.* I was very impressed with both the quality and depth of the writing. It was very insightful, but entertaining and fun to read as well.

Peter Bernstein: That book is first in my heart too, so that's delightful to hear. By the way, I should tell you that I'm working on a new book, *Capital Ideas Evolving,* which will essentially be volume two of *Capital Ideas.* It's scheduled to come out in the spring of 2007.

Ed Baker: And, to go along with your successes, I suppose we have to ask you what you consider to be your biggest mistake.

Peter Bernstein: I've thought a lot about this, and I'm going to be up-front with my answer. In 1967, we decided to allow my investment counseling firm,[2] which I inherited from my father and which I joined in 1951, to be acquired by a brokerage firm in what was to be Sandy Weill's first deal. We had good motivations for allowing the deal to go through. We wanted to get into the pension fund business and didn't want to take the risk on our own capital. However, it was a world about which I had no understanding, and even though the guys at the brokerage firm were wonderful to me, I could not stand the ethics, the heat, or the conflicts of interest, and I resigned in 1973. Looking back, allowing that acquisition is one step I'm sorry I took.

I should also include under this heading that in 1958, at the bottom of the market, I was a raging bear. I've always regretted that one, too, because I certainly was wrong.

Meir Statman: Did that teach you not to forecast the market or just not to make mistakes?

Peter Bernstein: Unfortunately, nothing teaches you not to make mistakes. But since that forecast, I've been a lot more humble.

Ed Baker: As a consequence, has your orientation been to stay long in equities through thick and thin?

Peter Bernstein: No, that has moved around. My views have changed. I can't say I've never expressed an opinion or a judgment, but I have been more guarded since 1958. The error in 1958 was an interesting one. Business was really bad at the end of 1957. Everyone was expecting the great post-war depression to come, and many of us thought this was the moment. What I failed to recognize was that there wasn't going to be a post-war depression, that this was a world with an entirely different economic structure and liquidity and a different role for the United States in the world—and all of that, certainly in the late 1950s, was going to prevent the return of a depression like we had in the 1930s. To be so focused on a major experience of the past and therefore fail to understand the present, in

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all of its manifestations, was where the mistake lay. I learned a lot from that, and today it is very important to understand that this is not 1995, it's 2006.

Meir Statman: Can you say something more about that? I was just about to ask, "What about 1995?" because, of course, the argument in 1995 was that the world had changed. However, it turns out it had not. In 1958, it did. How could you tell these apart?

Peter Bernstein: I think 1995 was easy. 1995 was too early to be a bear, although I was beginning to make some noises, but I hadn't yet. I was still bullish on the stock market in 1995. As time passed, I think that was easy to make that call. It was classic. I mean, it was classic that something was building. I don't think that call was so difficult.

Meir Statman: And what about the market now? Has it recovered too fast? Will it continue on down, as Robert Shiller might contend?

Peter Bernstein: I don't have a strong opinion on that.

Ed Baker: It's a lot easier to talk about the market in the past than in the present, isn't it?

Peter Bernstein: My sense is this: In the normal course of events, the market will fluctuate, but nothing awful will happen unless one of two things takes place. There are two enormously critical variables on the horizon that one can't time or be specific about, but they are there. One is the exposed position of the U.S. dollar, and I just don't think we'll get by without a crisis there. I think that requires a major hedge. The other is the whole geopolitical situation. I live in New York, and I live in constant anxiety about the state of the world. That's not an economic matter, but it's pervasive in all decisions and appetites for risk and so forth. If the housing boom collapses or business gets weaker—okay, well, we've been through those things before. That's nothing to necessarily make us run for cover. It's the bigger, darker things on the horizon that scare me.

Ed Baker: The geopolitical framework is more important than it has been in a long time, and for the first time people really are developing a global view and thinking globally about their investment portfolios. Do you see investors beginning to broaden asset allocations more globally?

Peter Bernstein: Yes, certainly in the institutional world. I was struck by something I saw in a *Wall Street Journal* article. I don't remember the exact numbers, but a very high proportion of IPOs (initial purchase offerings) in 2005 and to date in 2006 were made outside the United States in international markets all around the world. In many ways, talking financially, this is a very positive development. It means that we're not going to have a repetition of the Asian crisis of the 1990s. These countries are financially much better based and have more active and efficient markets. That's a powerfully positive element in the world economy.

Mark Anson: I'm based in London, one of those locations where many U.S. companies are listing. How much of that IPO activity do you think is due simply to regulatory constraints, specifically the Sarbanes-Oxley Act,[3] forcing the raising of capital offshore into other venues, such as London?

Peter Bernstein: I think the motivation behind Sarbanes-Oxley is a very important one. I don't know what chief executive officers read, but I probably read what you read. I said at the beginning about Sarbanes-Oxley that we run the risk that businesses are going to be taken over by accountants instead of risk-takers. I think that reform is an important motivation, but the consequence is very positive. I do worry about regulation. Of course, you have to be in favor of it, but you don't want to kill the goose that lays the golden egg.

Ed Baker: In the United Kingdom, we have more of a principles-based regulatory framework rather than a rules-based framework. That seems to be a much more constructive approach. Do you have any thoughts about that?

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Peter Bernstein: No question about it. Sarbanes-Oxley provides so many rules that it becomes extremely costly as well.

Meir Statman: Can you put this in the context of the 1930s, when the Securities and Exchange Commission (SEC) was established? I'm not sure Sarbanes-Oxley is the equivalent of that, but can you talk about the waves of "Let capitalism run" and "Let's rein in capitalism"?

Peter Bernstein: That debate's been going on since the beginning. Back in 1887, we had the Interstate Commerce Commission being established. I recently wrote a book about the Erie Canal, and I got the sense it went on back in the 1820s. It's a story that will repeat itself. The SEC was a more profound development than Sarbanes-Oxley, and much more far-reaching in whom it affected. The SEC established the idea of disclosure and transparency as the core of what regulation and the necessary conditions for good markets were all about. So I think the establishment of the SEC in 1934 was a much bigger event than Sarbanes-Oxley. The SEC was established more than 70 years ago, and it's still an active institution. Seventy years from now, nobody will know what Sarbanes-Oxley is.

Meir Statman: You were talking earlier about the 1950s post-war period and how the economic structure in the world had changed. That was also the time that the seeds of modern portfolio theory were sown. Did something happen at that time that could explain those two events, or was it just a coincidence?

Peter Bernstein: I think it was a coincidence. The sequence from Harry Markowitz in 1952 to Black and Scholes in 1973—that period of roughly 20 years—is almost spooky, because none of those economists was tuned into Wall Street. They were all in their ivory towers. They were talking to one another, but they weren't talking to investors. Suddenly, almost out of nowhere, there was this great leap, with entirely new thoughts, the biggest of which was that risk is as important as return. Thinking back over the whole history of human thought, there really isn't anything like those 20 years. In 1968, when I was still in the investment counseling business, my editor at Random House called me and said, "There's a very interesting young man we may be working with, and I'm sure you'd enjoy meeting him. His name is William Sharpe." So I called up Bill, a very charming young man, and asked him to lunch. We sat down and ordered a drink, then without any preliminary, he turned to me and asked, "Do you beat the market?" I nearly fell off my chair, thinking, "Nobody has ever dared to ask me that question. How can you ask me such a question? How could I be in business successfully if I didn't?" This was 1968, and I didn't feel that I was behind the eight ball in terms of my thinking. In fact, I think I was more intellectual than most. Bill and I have often joked about this incident, about how fresh he was.

Meir Statman: Was it that people didn't think about beating the market back then?

Peter Bernstein: People didn't think there was a problem; that is, professionals didn't think there was a problem—the market efficiency idea and so on. There was no formal way of thinking about it.

Ed Baker: I don't think there was even a clear idea that was the objective.

Peter Bernstein: That's also true.

Meir Statman: Is it the objective? I'm jumping ahead a little in talking about the role of financial advisers and wondering whether we have not gone too far in seeing beating the market as *the* objective.

Peter Bernstein: In those days, certainly in the kind of firm where I was, which was oriented toward "high-net-worth" individuals, as we'd say today, the sense was: "Come to us, and we'll take care of you. We can do this better than you can." We didn't talk very much about outperforming the market. However, when we sent out our quarterly reports, if we had beat the market, we always mentioned it. The market then was the Dow Jones Industrial Average. Without computers, you

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couldn't calculate the Standard & Poor's 500 Stock Composite Index more than once a month, and the Dow Jones average was figured only once an hour at that point. Somebody would sit down with a sheet of paper, add up the 30 stocks, and then divide. You're right, Meir, the investment adviser was judged in a different sense. However, by the late 1960s, it was getting very hot. The "go-go guys" were taking business from us. We lost a lot of business in 1968 to the hot guys, because we were not hot. I didn't know how to be hot, and to the extent that we tried to be so, we did badly.

Meir Statman: Can you say more about the state of the investment advisory profession right now, because it seems like there are two directions. One says, "We are here to beat the market, so don't bother us because we are busy looking for opportunities." The other says, "No, we are here to help you with your life and your life goals, and we are trying to take care of your well-being, not just your wealth." Do you see conflict between those two directions, any balance that needs to be struck, any thoughts you have on that?

Peter Bernstein: I think you're talking about two different worlds: the world of the institutional investor and the world of the individual investor. In the individual investor world, I think it's a terrible mistake to tell people you're going to "beat the market," or find all the mutual funds that are going to do that, because you don't know whether you will be able to accomplish that. To promise something that you don't know whether you can deliver is not only going to hurt the client but in the end hurt you too. I don't have to tell you that investing is a very complicated, very difficult business. It involves a wide range of expertise and thought and, above all, sensitivity to risk and the consequences of being wrong. To promise anything other than "I'm going to try to take care of you" or "I'm going to try to prevent the bottom from dropping out, and I can't even promise that, but I'm going to do my best" is wrong. I think that's obvious. One of the things about the investment advisory business that bothers me is the agency sort of problem, that they go from the fanciest investment committee of the fanciest institution down to the smallest investment adviser trying to entice a client into his arms. I think investment advisers have to be very careful about what they promise, be fee-only, and have everything transparent, or there will be more disasters.

Ron Kahn: I'd like to go back for a second. You were talking about 1952 to 1973, this great period when you had all of these people coming up with great ideas, and they're academics, rather than being in the market. From the perspective of your position at the *Journal of Portfolio Management* and elsewhere, you've seen academics leading practitioners to some extent. Then it seems that we went through a long period when all the interesting work was going on among practitioners, and now it looks like academics are doing interesting things again. Do you have any thoughts on that, or on what academia has to provide to investment management?

Peter Bernstein: I might express it a little differently, but that's a very important point. I've been thinking about that in relation to writing the new book. When I wrote the first version of *Capital Ideas* in 1989 and 1990, there were only three really interesting applications of academic theory in the real world that I could find. One was the Wells Fargo story,[4] which is still a great story. The second was Barr Rosenberg,[5] who was working very hard to bring the word and was gathering people who were willing to listen. The third was portfolio insurance,[6] which was a fantastic product—it didn't work the way Hayne Leland and John O'Brien thought it would—but it was really an intellectual leap that took theory and applied it in practice.

Today there really isn't any theoretical discontinuity, but implementation is all over the place, and all of the people who created the theories are in the implementation business. Burton Malkiel is in implementation, serving as a director at several investment management firms. Myron Scholes is running a hedge fund at Oak Hill Platinum Partners. They're all in business. Barclays Global Investors[7] is a mixture. The boundary between who's an academic and who's a practitioner is very vague. This has happened throughout the industry, and I think it's wonderful. Barr Rosenberg was the one who really broke that barrier, and Leland and O'Brien too. Then it began to accelerate, and now it's the whole story. When I interviewed Robert Merton for my new book,

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Bob was explicit in saying, "I'm not interested in doing theory anymore. I'm a plumber—I'm looking for ways to put all this stuff to work so that it will help people." If Bob Merton is a plumber, what are all of us?

Ed Baker: Presumably, as the academics gain more direct market experience, that will lead to additional insights.

Peter Bernstein: Yes, I would think so. Bill Sharpe—and I should have included him before—is deep into the retirement problem, and he has an entire book coming out on the subject. This mind, which developed the capital asset pricing model, now is into what is probably the most serious economic problem our society faces.

Meir Statman: Can you speak about the *Journal of Portfolio Management* in the context of academics and practitioners? What did you have in mind when you established it?

Peter Bernstein: I was reading the *Financial Analysts Journal,* which was called *The Analysts Journal* in those days, and that's how I became aware of the academic efforts going on. So I went to Gil Kaplan, the publisher of *Institutional Investor,* and I told him, "Gil, you can't be writing all this flashy stuff. There's something very serious going on. I've been reading about it in *The Analysts Journal.*" And Gil said, "You're the only person who reads that journal." So I shut up. Then came 1974, and he called me and said: "You're right. I think we should start a journal in this area." I wanted to distinguish the *Journal of Portfolio Management* from *The Analysts Journal* by insisting on making it readable, making it literary. For a long time, I was the copy editor as well as the main editor, and I worked to eliminate passive sentences, put it into English, make it fun, give the articles sexy titles and subtitles. It was very important to make people want to read it. I'm very proud of that. I think we made an exceptional contribution by making it cutting edge to put articles into plain English.

Ed Baker: Speaking of industry journals, there seems to be a lack of historical memory about the research that surfaces in journal articles. We see the same ideas coming up over and over again, being posited as new ideas. How do we get to the point where that doesn't happen? I'm not just worried about people getting credit but about the continuing evolution of ideas, rather than rehashing old ones.

Peter Bernstein: I don't find that as true as you seem to. Indeed, I'm impressed with the pace of innovation. For example, the idea of portable alpha, from what I've been able to learn, goes back to the late 1980s. Joanne Hill[8] at Goldman Sachs wrote something about it, and Marvin Damsma of BP America began to try it. It's a tremendous idea, one that's changing the whole structure of portfolio management and indexing and so forth. I find these types of things tremendously exciting in the vistas that they open. I'm more impressed with the new vistas that are being opened than with the rehashing of old ideas.

Ed Baker: The point is that you know that the idea of portable alpha actually goes back to the late 1970s. Barra also had recognized that alpha and beta could be separated.

Peter Bernstein: The idea actually goes back to Jack Treynor and Fischer Black in their 1973 article, "How to Use Security Analysis to Improve Portfolio Selection," where they say that the whole alpha idea is completely separate. I can't remember the exact language, but it is there in black and white. That two people who have entirely different views about the market can still agree about alpha is fantastic.

Ed Baker: However, most people who talk about portable alpha today don't have any sense of the historical framework, and they do think it's a new idea.

Peter Bernstein: I think that's okay. I mean, it would be nice if people had a better sense of the history. I hope they read my new book, because I have the story in there in some detail. But I don't think it's necessary whether they know that Treynor and Black thought of it or that Joanne Hill thought of it. I don't think you need to know that to appreciate the vistas that this idea opened.

Ed Baker: Why do you think this idea of portable alpha now is all of a sudden catching on?

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Peter Bernstein: The driving force was the widespread notion that we're in an era of low expected returns, and so people were scraping at anything. But then I think what happened was that the innate logic of the idea was too strong: Why should I pay the same guy to produce alpha who's producing beta? Maybe I can do it differently. It's not very complex. First of all, most people probably don't really think about alpha seriously enough, but once you ask yourself that question, the world suddenly changes. We also needed the whole derivative instrument business to become much more familiar and easy-to-use. It's a major coming together of a lot of key ideas.

Meir Statman: Is this related to your views on strategic asset allocation, that in some ways we have moved from a focus on, say, a static strategic allocation to the need to look for alpha?

Peter Bernstein: I'm not sure, Meir. I think I might put it the other way. Because the search for alpha now is separate from the search for beta returns, the policy portfolio has a tendency to be more static. I've taken care of that problem; that is, I've got my asset allocation under control because I've got it all indexed. I don't have to think about it. Now I have to look at where I'm going to get the edge. So, to some extent, the focus on portable alpha takes people's attention away from the asset allocation problem. I don't think it's really diverted from the asset allocation problem, but to the extent that portable alpha plays a role in this, it does take some attention from asset allocation.

Meir Statman: And properly so, or is that dangerous?

Peter Bernstein: No, it certainly is not proper. The alpha search, as I don't have to tell you, is somewhat ephemeral, and asset allocation is enormously important at every moment. I have to say, and again this is from research I did for the new book, that where people are really serious about the subject of risk—at places like Harvard, Yale, Princeton, CalPERS, Goldman Sachs—mean variance is still very much at the core of decision making. When Harry Markowitz said that you have to think about risk as well as return, that was the thunderclap, and it still reverberates. Wherever it doesn't reverberate, those people are going to be in trouble, such as the person running the hedge fund who thought he was a genius in buying energy while he had a dreadful risk-management structure. Someday I'm gong to write a piece called "The Perils of Brilliance." The times I have been most wrong are the times I thought I was most right. You asked me at the beginning about the things I've learned from all of this, and I have to repeat: It's humility. I think the reason I've been able to survive 55 years in this business is because I developed humility, at least after 1958. It's the only way to survive—not necessarily to be the top quartile—but survival is really the name of the game we're playing with long-term considerations.

Mark Anson: One of the things about humility I've learned in the markets is that the markets can be irrational far beyond my pain threshold. As you look around today, I'm curious if you see one or two valuations or themes in the markets that make you scratch your head and say this just doesn't seem to make sense.

Peter Bernstein: I think that kind of thing is always there, but I would join you in a larger statement. A long time ago, Paul Samuelson distinguished between micro-efficiency and macro-inefficiency. All of the forces in the market are working constantly toward greater efficiency—although they will never get there. Behavioral finance in itself has performed a huge service by drawing attention to an enormous variety of alpha opportunities that people hadn't thought of before. So that process goes on constantly all over the world. But the boom/bust thing is never going to go away; it's going to come back. I see no reason to think that it's ever going to end as long as the system is fair.

Ed Baker: In your previous answer, you mentioned mean variance. Although variance still is widely used as the primary assessment of risk, we know the use of variance has a lot of flaws and distributions probably aren't normal. In fact, if you move away from stocks, you have important characteristics of distributions with which variance obviously would not deal very well. What are your thoughts about that? Do you think that's a danger? Why has variance stuck around for so long?

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Peter Bernstein: Variance has two things in its favor: First of all, it's mathematically very convenient to use. Harry Markowitz came up with the concept, and he was an operations research person, so it was neat. That's the most compelling reason. However, I think it has a more important overtone. Volatility gets you in the guts. There's no question that when prices are jumping around, you feel different from when they're stable. You say to yourself: "What does somebody else know that I don't know? What's going on that I don't understand?" Variance is a proxy for risk, in a gut sense. Now maybe it's too short-term; maybe you shouldn't respond to it. But it's not just the mathematical aspect of it. I think there's a psychological aspect too. Nevertheless, there is no question that the focus on variance a) makes people too oriented to the short-term and b) adds all the mathematical limitations that you mentioned. The basic idea is what Harry said in English rather than in math, and that is you have to consider risk as well as return. If you think about everything in the way of implementation that has developed since Harry first talked about this in the early 1950s, and the tools we've developed since then, and yet none of them are really designed to get better returns, because we'll never know how to do that. They *are* designed to figure out how to incorporate risk into the decision. It's knit into the fabric, and we're not going to get it out again.

Meir Statman: Mark Anson would know more about this than I do because he was with CalPERS, but from what I understand, CalPERS uses constraints, fairly severe ones, that I could see really driving the solutions to asset allocation more than the optimizer itself. It seems to me that is what is generally done. I wonder whether this does not undermine the argument about mean variance. That is, people have a very strong intuition about what proper asset allocation is, and if they get something different from the optimizer, they fool around with it until they get what they wanted in the first place. Mark, is that accurate?

Mark Anson: Yes, that's true. CalPERS runs a constrained optimization. They start with the efficient frontier as devised by Markowitz, taking into account—as you said, Peter—risk woven into the fabric of portfolio management and asset allocation. But then constraints are thrown on top of that, and those constraints could be behavioral, they could be political from time to time, and they could also be pragmatic. For example, if you run any optimizer and put hedge funds into the mix, the optimizer will allocate a ton of money to hedge funds. CalPERS couldn't possibly invest the tens of billions of dollars into hedge funds that an optimizer would suggest. It's just a pragmatic constraint. So you get an efficient frontier, but it's an efficient frontier with constraints placed upon it.

Peter Bernstein: In a sense, both Meir and Mark are right. Meir said that a person can get any outcome he wants from an optimizer by using constraints. On the other hand, they're very difficult to avoid because by its very nature, the optimizer loves things with low correlation. One of the interesting things I discovered in researching my book is how this is handled at Goldman Sachs, where Fischer Black's hand still presses hard on the way people think. They combine an equilibrium model with their optimizer, and they give the equilibrium model a view along with whatever their own views may be about the state of the world. I think everybody recognizes the mechanical shortcomings of the optimizer, but no serious investment institution today makes an asset allocation decision by simply saying, "I think we like stocks better than bonds" or "Let's go 60/40." It's a more systematic process than it used to be. Everyone develops his or her own system, but it's not seat-of-the-pants anymore. Well, it's not seat-of-the-pants anymore except to the extent that people copy one another. Someone goes into hedge funds, and then everybody goes into hedge funds. You're never going to eliminate that problem. That's not to say that hedge funds are not a wonderful innovation, not only because of the high returns at the beginning but also because they made short-selling an important element in managing money.

Tony Kao: I wanted to ask you your opinion about the transformation of defined benefit plans now that people are talking about frozen plans. What is your view on what this has meant to individuals, as well as on what kind of product design needs to be done?

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Peter Bernstein: I don't know how to design a product, but I can answer the other part of your question. It's awful, awful, awful. I'm writing a piece now for my newsletter about the background of the equity risk premium, so I've been thinking about this problem a lot. From the end of World War II to the end of the 1960s, the bond market went steadily down, and the stock market went almost steadily up. Looking back, the whole thing looked so easy, but these are such difficult kinds of questions. That period was almost the inverse of what has happened since 2000, and that's what ruined the defined benefit business. The bond market went up, and the stock market went down, and the defined benefit business got into deep trouble. If that hadn't happened, I don't think the idea of defined contribution plans would have gotten anywhere. That's really the tragedy, and I don't know how you put the pieces back together again. To throw the risk on the individual—I think it's a catastrophe.

Tony Kao: What kind of catalyst do you think it would take to bring back the defined benefit plan?

Peter Bernstein: I really don't know how you would put it back together again. I don't think corporations—to the extent that they recognize the real nature of this obligation—are going to willingly go back into the defined benefit plan.

Tony Kao: What role do you think investment advisers and financial planners need to play as defined contribution plans become a more important part of retirement assets?

Peter Bernstein: Obviously, it's a very important role because individuals need that advice and guidance. I also think the present trend toward life-cycle funds[9] is very beneficial, because these funds help individuals make decisions ahead of time. But the financial advisory profession should also be involved in that. At one end of the spectrum, you have Financial Engines, Bill Sharpe's business,[10] but there are many other ways financial advisers can help individuals frame and design their retirement choices. There should be a lot of opportunity ahead for advisers, because I don't see us going back and re-establishing the defined benefit plan as the typical plan.

Ed Baker: What role should investment consultants be playing in all of this? I mean the people who are advising the individuals as to what to do with their assets, not necessarily the people who are actually running the money, but those who are providing the consulting advice.

Peter Bernstein: The difficult thing for the financial adviser and the client—and I learned this when I managed money—is that no one can really identify how he or she is going to react when surprises come along, and yet surprises are inevitably going to come. Somehow investment consultants need to condition people to this fact. I give a lot of talks where I stand up and say, "We don't know what the future holds," and I see all of the heads nodding up and down. But people act as if they do know what the future holds, and that's what gets them into trouble.

So it's crucial that consultants try to get through to people that it's impossible to know the future and that surprise is inevitable. As a result, we have to limit the nature of our bets, we have to be obsessive about diversification, we shouldn't try to be too smart, we shouldn't try to shoot the moon. All of these are very simple ideas, and people will accept them ahead of time, but it's hard for them to live with humbly structured portfolios. However, they have to do so if they're going to survive. The main thing that an investment consultant can do is to get through this idea that you can't act as though you know the future if you want to be a survivor. The future may be better than you think, and it's not necessarily going to be worse. But even if it's better than you think, that's also hard to handle. It's that kind of philosophical teaching that consultants have to understand in their hearts, and then get it into the hearts of investors. Once you've got the philosophical grasp, the rest is easy.

Meir Statman: Can we connect this back to your comments about ethics and integrity at the very beginning? I think that one of the problems that financial advisers face is that investors come to them thinking that they are going to get the advisers' services for free. So advis-

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ers respond by hiding their fees, and so on. Do you see a way to clarify this situation so that it is more like the relationship between physician and patient? The investor comes in, he pays the fee, and things are reasonably transparent.

Peter Bernstein: I know, Meir, that's the goal; that's the way it should be. When I started in the investment counsel business, the idea that you would pay a fee for advice instead of going to a broker—well, people didn't even know such a thing existed. Now that's regular operating procedure in the institutional world. Individuals just have to learn—and learn the hard way—that if you take on someone to give you advice who's got agency problems and conflicts of interest, then good-bye. Certainly the financial adviser associations are working hard on the ethical problem, and that's good, because the only way the advisers are going to survive is to be clean.

Meir Statman: Has ethical behavior changed over time? Is it better now than it used to be?

Peter Bernstein: No. I look back over the past ten years, and in my memory anyway, I don't remember levels of corruption—to use a general word—everywhere to the degree that it is today. By everywhere, I mean it's in the United States, it's outside the United States, it's in the heart of Congress, in the heart of the administration, in the heart of every political and economic set-up, and I don't know how you get it out. Once it's that widespread, it's extremely difficult to dislodge. For example, as part of a campaign to fight corruption in developing countries, Paul Wolfowitz at the World Bank is trying to restrict grants to countries where there's no corruption, and they can't find anyplace to give money.

Ed Baker: Would you say that's also true of corporate governance practices? Have they deteriorated, or have they perhaps improved?

Peter Bernstein: Maybe there's been some improvement since 2001, and I think there has been. However, the corruption was so pervasive and went so deep. You still pick up the paper every day and there's news of hanky-panky going on. It's very depressing. It was not like this in 1951—or 1961—or even 1971. The 1990s were a marvelous decade in some ways—and a catastrophic one in other ways. There was open greed in a way I don't think existed since Midas.

Roger Edelen: When you say that corruption has infiltrated even the government now, do you have anything specific in mind in the context of financial markets?

Peter Bernstein: I'm really not that active in the market, so I only know what I read. I think the markets on the whole, the financial areas, given the temptations and the complexities of what goes on there, are better than the rest of the world. I don't know why that is so, perhaps because there is more supervision and a greater tradition of supervision. It's interesting that we went through the crash in 2001 and nothing blew. When you think about the nature of the bubble and all the games that were being played all around the world in a very complex fashion, the crazy things that people were doing, and then this tremendous deep shock, but the financial structure survived it, that is, no bank failed, no major brokerage failed. A couple of corporations that exposed themselves to that shock—like Enron—went down the tubes, but nothing really blew. There was no systemic damage, and that is very interesting. I think that the whole risk-sharing process is the answer to the question of how we avoided systemic damage, and that the people who worried that derivatives were going to be the spark that would light the fire had it exactly wrong. Whether that would be true the next time around, I don't know. If the exposed position of the U.S. dollar leads to a crisis, as I suggested earlier, who knows what will happen.

Ed Baker: Looking at the future, what do you think is in store for us? I don't mean in terms of markets, but in terms of financial or academic innovation.

Peter Bernstein: My sense is that—if you take short selling and portable alpha as the big innovations of the past few years—we are only at the beginning of the process of innovation. And that process will continue as things we haven't even begun to think of today will

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come about. We have this enormous range of financial instruments with which to play, and enormous goals to make money and to manage and share risk. I'm sure that even just five years from now there will be things to talk about that we're not even aware of at the moment.

Ed Baker: I'd like to thank you, Peter. If we weren't time-constrained, I know there are a lot more issues we'd like to probe more deeply.

Peter Bernstein: You have all been wonderful. I got a lot off my chest, and I appreciate the opportunity to do so.

ENDNOTES

1. John Maynard Keynes was a British economist whose ideas, referred to as Keynesian economics, had a major impact on modern economic and political theory as well as on the fiscal policies of many governments. His most important work, *The General Theory of Employment, Interest, and Money,* which was published in 1936, laid the foundation for the branch of economics called macroeconomics.

2 Bernstein-Macaulay, Inc., which was founded in 1934 by Allen M. Bernstein and Frederick R. Macaulay, was acquired in 1967 by the firm of Carter, Berlind & Weill, in which Sandy Weill, later the chief executive officer and chairman of Citicorp, was a partner. Carter, Berlind & Weill went on to complete a number of other acquisitions (and name changes) to become the country's second-largest securities brokerage firm before being sold to American Express in 1981.

3. The Sarbanes-Oxley Act of 2002, also known as the Public Company Accounting Reform and Investor Protection Act of 2002, which was enacted on July 30, 2002, is a U.S. federal law passed in response to a number of major corporate and accounting scandals. The legislation established new or enhanced standards for all U.S. public company boards, management, and public accounting firms.

4. Wells Fargo Bank played a revolutionary role in applying new academic theories to its investment management business. In 1971, James Vertin, William Fouse, and John McQuown of Wells Fargo established the first indexed pension account for Samsonite Corporation, based on an equal dollar amount of each of the 1,500 stocks on the New York Stock Exchange. McQuown, along with Rex Sinquefield at American National Bank in Chicago, also established the first S&P 500 index funds in 1973.

5. Barr Rosenberg was a pioneer in exploring the relationship among beta, common factors in security returns, and investment fundamentals. As well as gaining widespread acceptance for beta as the measure of risk for stocks, Dr. Rosenberg also is credited with transforming the concepts of academics such as Harry Markowitz and William Sharpe into tools that paved the way for practices used by today's investment consultants, including the concepts of risk budgeting and portable alpha.

6. The portfolio insurance strategy was developed by University of California, Berkeley academics Mark Rubinstein and Hayne Leland and marketed by Leland O'Brien Rubinstein Associates.

7. Barclays Global Investors introduced the world's first index strategy in 1971 and the first quantitative active strategy in 1977 and also offers a broad range of investment products.

8. See Eduardo Schwarz, Joanne Hill, and Thomas Schneeweis, *Financial Futures: Fundamentals, Strategies, and Applications,* Homewood, IL: Irwin, 1986.

9. Life-cycle funds, or target-date funds, minimize asset allocation decisions by allowing participants to choose a single investment option that matches their age and retirement date.

10. In 1996, William Sharpe, who was awarded the 1990 Nobel Memorial Prize in Economic Sciences, cofounded Financial Engines, a firm that provides online investment advice and management for individual investors. He still is involved with the company and currently serves on its board of directors.

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