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Measuring the measurers: the economist as performer

Leading economists manage the American Economic Association's equities. So how good is their track record?

Sheen T. Kassouf

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"If economists could manage to get themselves thought of as humble, competent people, on a level with dentists, that would be splendid!"

JOHN MAYNARD KEYNES

For the past decade, academic economists have analyzed and measured the investment performance of professional money managers with an intensity and zeal usually associated with proselytizing religious converts. This new-found religion based on the old testament of Markowitz with new chapter and verse by Sharpe¹ has even contaged Wall Street. Naive measures, e.g., how much a manager made for his clients in the last bull market, are rightfully exposed as fraudulent. Sophisticated risk-adjusted measures utilizing the statistical technique of linear regression and strewn with arcane labels (beta analysis, alpha differentials, sigma, R-squares, etc.) have flooded not only the scholarly journals but even the coffee table magazines and brokerage house letters. Mutual funds, banks, insurance companies, and independent investment advisors have all come under the searching stare of academics.

The professors' conclusions are unequivocal (to them) and unanimous: money managers from whom data can be coaxed or for whom data are publicly available fall short under risk-adjusted measuring rods. With the brutual frankness they consider scientific ob-

jectivity, economists' suggestions to the professional managers range from hara-kiri to ceasing and desisting.²

A RICH AND UNEXPLORED DATA BANK

It is now said that the supply of new business school MBA's is severely limited by the lack of new performance data to be analyzed. It is curious, therefore, that a rich data bank has been innocently overlooked: the American Economic Association's equity portfolio. We correct this neglect by now examining, using the tools and yardsticks of the new capital market theory, the performance of the Association's investments.³

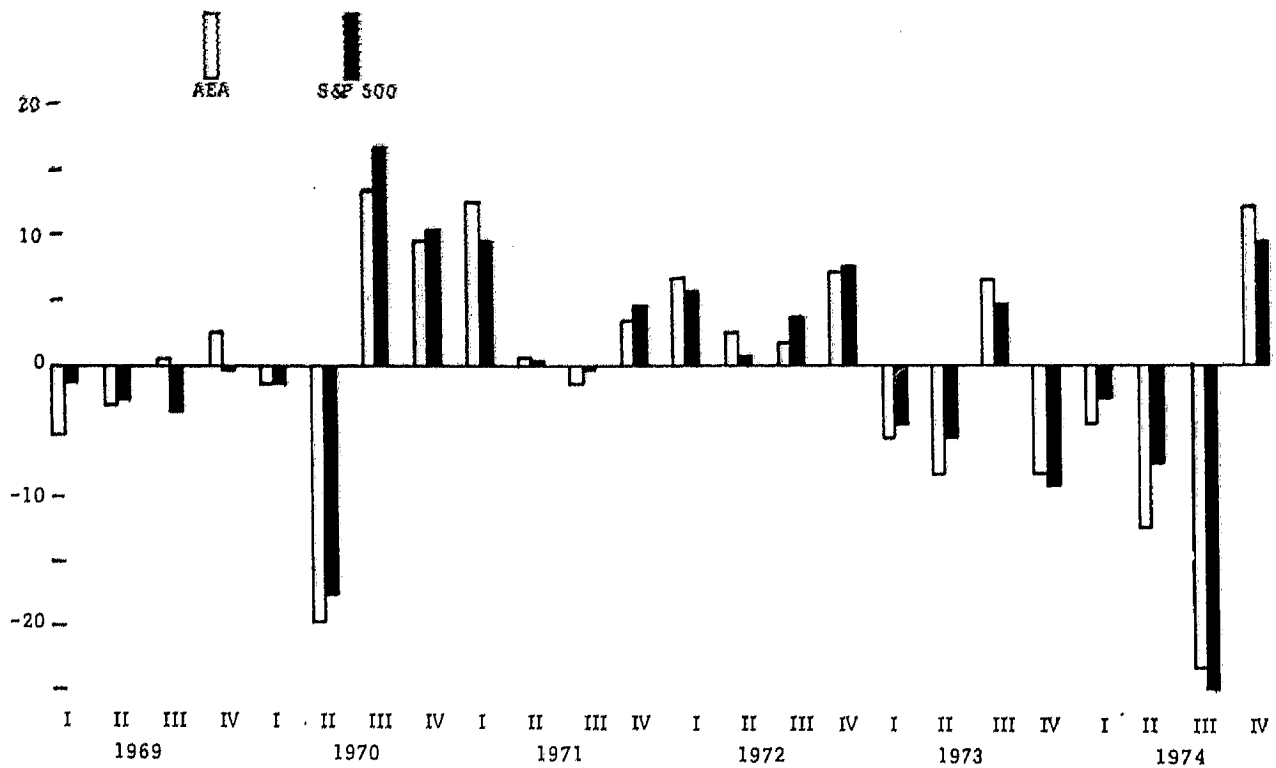
Data on a quarterly basis are available only for the period subsequent to January 1, 1969. Prior to that, only annual data exist and these were somewhat in conflict with the annual auditor's reports. Consequently, we restrict this study to the twenty-four calendar quarters ending with the last quarter of 1974. The accompanying chart compares the quarter-by-quarter total return of the AEA's portfolio with that of the S&P 500. Perhaps this visual inspection suffices: the AEA portfolio was remarkably similar to the broad market represented by the S&P 500 average. The unaided eye, however, is frequently misled, so we present the following statistics:

	AEA	S&P 500
average total return per quarter, %	-0.65	-0.44
standard deviation of return, %	9.55	9.10
compound annual growth rate, %	-4.36	-3.39

Over this six-year period, the AEA portfolio usually consisted of about thirty to thirty-five stocks. In spite of the relatively small number of issues, this portfolio aped the S&P 500 remarkably well. Index

1. Footnotes appear at the end of the article.

QUARTERLY TOTAL RETURNS, %



funds would have been proud of this record.

Even these summary statistics do not sufficiently satisfy the new capital market theorists. They are not "risk-adjusted." Following Sharpe, excess total returns for each quarter for the AEA and S&P 500 were calculated by subtracting from the actual return the riskless return available on 90-day Treasury bills. Then the AEA's excess return was regressed on the S&P's excess return to yield the following estimating equation:

$$AEA^e = -0.18 + 1.02 S\&P^e$$

(-0.35) (18.6)

$$R^2 = .937, SE = 2.42$$

where the superscript indicates excess return and the numbers in parentheses indicate the t-statistics of the coefficients. The coefficient of 1.02 is not statistically different from 1.00, indicating that the volatility of the AEA portfolio was essentially equal to that of the market. The negative constant, or alpha term, suggests that the risk-adjusted performance of the AEA portfolio was somewhat inferior, losing 0.18% per quarter more than the risk-adjusted market portfolio. But again, the t-statistic indicates that the "true" alpha could easily have been zero, making the AEA portfolio statistically indistinguishable from the S&P 500 average.

Professor Samuelson, the most distinguished member of the AEA, has called for an AEA sponsored index fund.⁴ In his wildest dreams he could not ask for more than this, and the course of action is clear: when such a fund is set up, it should be managed by the Finance Committee of the AEA (please note that, for the past few years, this Committee has included the highly respected Milton Friedman, Walter Heller, and Beryl Sprinkel).

SOME MODEST PROPOSALS

Before plunging ahead recklessly, an observation must be made. The Committee reports should not be written by its present members. To paraphrase an erstwhile attorney general, we are better advised to watch and admire what they do rather than listen to what they say. Their annual reports read like the reports of all other conventional managers. They discuss the previous year's results with naive measures, forecast the probable future economic climate, and then claim to choose an investment posture based on this forecast. The entire procedure denies the evidence their colleagues have so painfully collected with regard to efficient markets: buy and hold is the strategy that dominates all, and the manager's primary function is to optimally diversify.

By this criterion, the evidence is conclusive that

the Finance Committee has done a superlative job. The tenor of their remarks indicates that they have been unable to completely exorcise that demon residing in us all — that demon who whispers that if we look a bit harder, we will know when to get in and out of the market and/or we can detect those issues to embrace and those to avoid. The demon serves a useful purpose and adds zest to our work, but scientists should never admit, in print, to his influence.

A final suggestion. The AEA should be in the vanguard of the investment community. In its search for optimal diversification, it can no longer overlook the utility of the optioned equity portfolio. Properly constructed, it can dramatically reduce volatility of return and simultaneously increase the long-run rate of growth.⁵ Neglecting the use of options unnecessarily restricts the feasible region in Markowitzean space; their intelligent use raises the efficient boundary significantly. This is well-known to many members of the Association, e.g., Samuelson, Merton, Black, Scholes. The time has come for the Association to lead

the way. Constructive criticism from the ivied tower is fine, but superior example is finer.

¹ See "Adjusting for Risk in Performance Measurement," by W. F. Sharpe, and "Diversification: Old and New," by J. H. Lorie, in this *Journal*, Winter 1975, Vol. 1, No. 2.

² Although it is a tiny sample, economic giants seem to have talents not available to professional money managers. Ricardo, a giant of the 19th Century, Keynes of the 20th Century (and by some preliminary casual evidence, Samuelson, our native Nobel laureate), all have been successful market participants. The record is marred somewhat by Irving Fisher's unfortunate forecasts in the late 1920s.

³ The author is grateful to B. W. Sprinkel and R. Fels for providing the raw data.

⁴ See "Challenge to Judgment," by P. A. Samuelson, this *Journal*, Fall 1974, Vol. 1, No. 1.

⁵ See "Rates of Return to Option Writers on Dow-Jones Industrial Stocks, 1961-1971," S. T. Kassouf, *The Wall Street Review of Books*, Dec. 1974, Vol. 2, No. 2.