JOIM
www.joim.com

JOURNAL OF INVESTMENT MANAGEMENT, Vol. 2, No. 3, (2004), pp. 62–64
© JOIM 2004

BOOK REVIEWS

Mark Kritzman, Senior Editor

CAPITAL—THE STORY OF LONG-TERM INVESTMENT EXCELLENCE

By Charles Ellis
(Reviewed by Edouard Stirling)

The contributions of Capital to building wealth for private and institutional investors are tremendous. This success is highlighted in the net long-term outperformance of very sizeable Capital mutual funds countable not in single or double digit basis points but in hundreds of basis points. Such long-term growth also helps explain how a small asset manager with just over 12 mn USD in 1931 managed to grow to over 650 bn USD in 2003 (doubters of the benefits of long-term compounding should note that this growth is "only" a modest 16% per annum). Any firm which can generate this type of long-term performance not only stands head and shoulders above many competitors but also demands the attention of analysts and commentators. Charles Ellis does the financial community a great service by focussing his considerable experience and powers of analysis on this unusual institution. *Capital* is a story of entrepreneurship, leadership, luck, vision, ethics, and culture as well as, of course, people.

I dare say that there are few practitioners who will not come away from *Capital* enriched. Students of entrepreneurship and leadership will appreciate how great firms are managed and composed in order to ensure long-term success. Portfolio managers will find in *Capital* an exceptional exponent of extreme long-term bottom-up value investing. Sales teams and business strategists will learn from a culture which infuses client dialogue with the firm's exceptionally defined values. These seek to generate value through simultaneously servicing three core constituencies of shareholders, investors, and employees. *Capital* believes these constituencies have interdependent interests and that exceptional success will not be delivered by neglecting one group's interests.

One of the great ironies of *Capital* is, of course, that we find Charles Ellis, a well-known supporter of indexers, enthusing about an animal which is anything but an indexer. Given the perennial ferocity of the active–passive debate, it might be too much to hope for this circle to be squared here. It is perhaps a little disappointing that this irony is not explored more assiduously by Ellis himself although it is readily and immediately identified. Can it really be so simple that the market jungle needs to have stock picking animals earning above average rents. Their presence ensures that prices adjust to new information promptly to the benefit of all the

Not for Distribution

other denizens . . . including the indexers themselves?

What is clear is that the firm portrayed in *Capital* very quickly began to adopt measures which would contribute to long-term success. The first of these was an over-riding focus on the long run itself not only in investment decision making but also in planning. Very often costs were incurred and losses born by the partners for substantial periods of time in order to ensure that concerns of quality, service, or product mix were addressed. One case in point is Capital International itself. This business division was initially set up in an environment of anemic interest in global investing and suffered "20 years of continuous losses."

Another early innovation is a deceptively simple process of delegating portfolio management responsibility to groups of individuals instead of to one central individual. This "multiple counselor system" ensures a multi-dimensional, distributed approach to risk taking which allows active risk and portfolio diversity to be maintained even in relatively large portfolios. The approach to maintaining alpha in larger portfolios is symptomatic of a desire by *Capital* to build inherent flexibility into their way of doing and managing. This is further exemplified by *Capital*'s tendency to spin groups off from the core.

Charles Ellis presents the whole in an easy going style. Chapters are prefaced with more personal comments about the key themes he feels that the firm needed to manage in order to address the issues of relevance in the respective chapters. Throughout, Ellis elects to focus on key decision makers in order to center the narrative at the level of the decision makers. As an industry commentator intimately involved with the consulting business over the last 30 years, Ellis brings a wealth of experience and connections to a fascinating story which cannot fail to entertain or to enrich.

ASSET PRICING AND PORTFOLIO PERFORMANCE

By Robert Korajczyk
(Reviewed by Craig W. French)

One might wonder, since the bulk of Robert Korajczyk's *Asset Pricing and Portfolio Performance: Models, Strategy and Performance Metrics* (London: Risk Books 1999) is available through JSTOR and at public libraries at virtually no cost, whether it is reasonable to spend two hundred dollars on such a volume. This consideration certainly crossed my mind. The correct conclusion is in the affirmative, for there are two valuable sources of alpha in this collection of nineteen of the most influential works in the financial economics literature.

First, Dr. Korajczyk's introduction provides a clear and concise survey of the twin topics of asset pricing and performance evaluation. The nineteen papers, whose reprints comprise the book, are grouped into four primary categories—Section 1, asset pricing theory; Section 2, tests of the models and anomalous empirical evidence; Section 3, structural market imperfections; and Section 4, performance evaluation. Dr. Korajczyk does a commendable job of discussing these areas of financial economics and provides a nice contextual framework for the papers he has selected.

The second source of value added is Chapter 2, which, for the first time, publishes the capital asset pricing model (CAPM) that Jack L. Treynor developed in 1962. This paper alone is worth many times the cost of the book. Although Treynor (1962) was circulated during the 1960s and has been cited (usually with the inaccurate date of 1961) in important seminal papers of prominent financial economists, the paper had heretofore fallen by the wayside in the history of the CAPM. Prior to publication in *Asset Pricing and Portfolio Performance*, Treynor (1962) was not publicly available, and could only

Not for Distribution

be found in private collections. Dr. Korajczyk has done both the academic and practitioner communities a great service by publishing Mr. Treynor's CAPM.

Section 1 includes Treynor (1962), Sharpe (1964), Merton (1973 and 1987) and Ross (1976). These works introduced the single-period discrete-time CAPM, the intertemporal CAPM, the APT, and the extension of the CAPM to include asymmetric information. I would have liked, if not the paper itself (as a chapter), to see at least some discussion of the important interpretation of Fama (1968) in Dr. Korajczyk's introduction. Also, no mention of Rubinstein (1973) is made, which incorporated higher moments well before Ingersoll (1975) and Kraus and Litzenberger (1976), and also derived the CAPM without a riskless asset, independently of Black (1972).

Section 2 comprises some of the noteworthy tests of asset pricing models and the anomalies that have been found as a result. The papers of Fama and French (1992 and 1996), Jegadeesh and Titman (1993), Daniel and Titman (1997), Brennan, Chordia and Subrahmanyam (1998) and Ferson and Harvey (1991) can be found here. While Section 1 focusses on early work, Section 2 avoids the original research in this vein, such as the papers by Black, Jensen and Scholes (1972) and Fama and MacBeth (1973). However, their findings are discussed in Fama and French (1992), which is reprinted as Chapter 6, so the reader is not too deprived by their absence. Of course, a single volume is hardly enough to contain much of the anomaly literature, and Dr. Korajczyk chooses to focus on collections of anomalies and/or models, which necessarily excludes the earliest work. This choice offers an economical presentation of a broad scope of work in the territory.

Section 3 offers three papers that explore two market frictions—transactions costs and illiquidity. Amihud and Mendelson (1986), Brennan and Subrahmanyam (1996) and Jagannathan and Wang (1996) explore these areas. While Dr. Korajczyk discusses the earliest contribution, that of Mayers (1973), in his introduction, I wish it too had been included as a chapter in this section.

Section 4 presents five excellent studies on the topic of performance evaluation, including Grinblatt and Titman (1989), Jagannathan and Korajczyk (1986), Leland (1999), Ferson and Schadt, (1996), and Brown, Goetzmann, Ibbotson and Ross (1992). Dr. Korajczyk does an impressive job of reviewing the literature on this topic in his introduction, covering the early studies of Treynor (1965), Sharpe (1966), Treynor and Mazuy (1966), Jensen (1968), Jensen (1972), Treynor and Black (1973), as well as most of the important later studies. However, I was disappointed not to see any discussion of Carhart (1997), which really deserves to have been included as a chapter in the book.

In summary, the consolidation of these important papers into a single volume provides a convenient reference text for both students of finance and investment professionals. My few points of criticism essentially indicate a wish for more. *Asset Pricing and Portfolio Performance* is a large volume that stands tall on my bookshelf, dwarfing more manageable tomes such as Merton's *Continuous-Time Finance*, Markowitz' *Portfolio Selection* and Cox and Rubinstein's *Options Markets*. With its attractive cover art, it would also sit comfortably on the coffee table. Those who prefer British spelling conventions will be especially pleased with this book. Dr. Korajczyk has produced a useful and unique compendium that deserves to find its way into the library of every academic and practitioner in the investment community.

Not for Distribution