The Journal of Portfolio Management

Staying the Course

Peter L. Bernstein

Imagine a mutual fund similar to conventional funds except for two unique features. First, the shareholders of this fund are not individuals but family units; hence, transfers of shares pass only down generations in family lines. Second, the shares are not redeemable until a date far off in the distant future, although, as with a long-term bond, time inexorably brings that terminal date closer every day. Meanwhile, however, principal is locked up, untouchable.

There is such a fund—the Smith Company, which has been functioning for many years. This issue of the Journal carries the president's letter in its annual report for the year 2000. We decided to publish this contribution because of the way Smith's peculiar prism illuminates the events of that tumultuous year. The perspective is interesting in its own right, but the report is a model for investors in a more general sense. It demonstrates how clarity of viewpoint, simplicity of strategy, and a long-term horizon, consistently applied, can aid understanding and lead to rational decision-making.

The fund's investment objectives are stated at the outset, and the very first is a rare bird in today's world: "To provide over the long term a stable dividend payout in inflation-adjusted dollars." Long-term capital appreciation, the more conventional primary objective, is relegated to Objective #2, which describes the purpose of growing the principal as "the expanding capital base required to achieve Objective #1." Capital appreciation is only a means, not an end! After a bow to risk management as Objective #3, Smith's dividend policy does recognize that the long investment horizon calls for the usual fiduciary concerns of balancing the interests of future as well as present recipients.

When I first encountered the Smith Company many years ago, I was shocked at the downplaying of capital appreciation. Its holders laughed at me. Why should fluctuation in principal matter, they argued, if you will never spend that principal, or will spend it only at a far distant time in the future? Income, meanwhile, would be the only money shareowners would touch, accumulate, or spend. To use the Smith metaphor, the production of eggs clearly dominates the value of the chickens.

This viewpoint has great advantages. It simplifies the asset selection parameters to permit heavy emphasis on growth, dividend-paying, equities. It keeps the managers cool, even happy, in bear markets. Volatility is welcomed as an opportunity to refresh the portfolio—eliminate sleepyheads and acquire younger growth—with smaller tax consequences than in a roaring bull market. In other environments, the strategy tends to hold portfolio turnover to a minimum, thereby minimizing turnover's high costs and tax consequences.

Bonds in this environment are counterproductive; the company has gradually built up a small municipal bond portfolio, not to cushion volatility but only as a fail-safe against deflation that might threaten dividend income. Along the way, as the managers have learned from their experiences in managing the tax consequences of portfolio turnover, they have recently sought routes to build a small exposure to value investing while minimizing capital gains liabilities.

That unusual emphasis on income can be highly instructive for all of us. There is much to learn from the Smith Company's president's report of the crazy year of 2000.