

THE EDUCATED INVESTOR

Summer 2001

Staying Power

We all have noticed that Alan Greenspan and colleagues have been very busy lately combating a weakened US economy. To date in 2001, the Federal Reserve has lowered interest rates a startling six times – for a total 2.75 percent drop. What does this mean to the long-term investor?

Whether times are good or times are bad, we steadfastly advise investors to avoid making buy, sell or hold decisions in reaction to short-term market trends. Here are key points to remember when your investment staying power may be weakening.

Start with a Plan

Minimizing emotional response to market movements is an important part of the investment process. A written investment policy statement helps thwart such behavior. Discuss your objectives in advance with your investment advisor, and build into your plans the inevitable downturns and upswings. Creating an investment policy devoid of the emotional pitfalls to which we can fall prey helps maintain the discipline to achieve your goals.

Diversify Globally

It is human nature to assume that familiar means safe. A study by Kenneth French and James Poterba revealed that US stockholders held 94 percent of their equities domestically, while Japanese and UK investors held more than 85 percent of their stock in domestic firms.¹ Investors worldwide shy from international investments,

presumably believing that the unfamiliar is too risky. Additional studies indicate quite the opposite. A Fall 1998 *Journal of Investing* article by David Laster indicated that adding an international component to a portfolio actually reduces overall risk. Any combination of the S&P 500 Index (US stocks) and EAFE Index (European, Australasian and Far East stocks) outperformed either index individually during the 27-year study period (1970-1996). In a separate study, S&P's Chief Investment Strategist David Blitzer analyzed a portfolio of 60 percent US and 40 percent international holdings during a 30-year period. No single country produced a higher return than did the overall portfolio, and the standard deviation (a measure of the portfolio's volatility) was less than that of any single country. By diversifying globally, investors earned higher returns with less volatility compared with holding any individual country's index.²

Invest Tax Efficiently

Of course the recent Federal Tax Law is on everyone's mind as a potential jump-start for the US economy. While its full impact remains

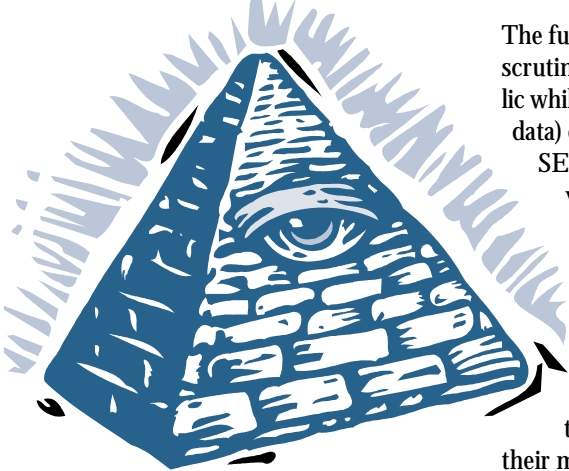
unknown, there are indications that it will provide several new opportunities for generating tax-exempt income. For the taxable portion of your portfolio, passively managed fund families such as Dimensional Fund Advisors, Schwab and Vanguard have been adding tax-managed funds to their product menus, resulting in more options than ever to maximize tax-efficient investing. Such tax-managed funds can improve on the tax efficiency of index funds by adopting the following strategies:

- ▲ Avoiding realization of short-term capital gains
- ▲ Harvesting losses as available to offset realized gains
- ▲ Increasing buy and hold ranges to reduce turnover
- ▲ Trading around dividend dates

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Within the Eye of the Beholder



Browsing mutual fund advertisements, one commonly sees indications of stellar returns. You might wonder how so many funds manage to perform well above average. By taking advantage of data and reporting biases, fund companies can tout performance whose beauty may only be skin deep. Here are some cosmetic tricks of which investors should be wary (especially for **Small-Cap and Micro-Cap Stock** funds, which seem most susceptible).

Survivorship Bias

Funds with poor performance can “disappear,” often by being merged into a better fund. In 1986, for example, 568 stock funds returned 13.4 percent. By 1996, performance from 1986 had magically improved to 14.7 percent. What happened? Twenty four percent of the funds had disappeared, skewing performance numbers after the fact.¹

Incubator Fund Bias

Incubator funds are newly created funds, each owning a different group of stocks and seeded with fund families’ own capital.

The funds “incubate,” safe from public scrutiny. Eventually, the best one goes public while the losers (and their performance data) disappear. Unfortunately, a recent SEC ruling allows reporting of the surviving fund’s pre-public performance, potentially distorting reality.

The IPO Game

The Initial Public Offering (IPO) game is one sometimes played by large mutual fund families. If they divide an IPO allocation among their many funds, there would be minimal impact on each from any potential first-day price increase. However, if they give the entire allocation to their smallest fund, the impact can be dramatic. The small fund turns in a great year, receives a five-star rating, and awaits the rush of new investors who are unaware that the supercharged returns are unlikely to repeat. A large fund family might also play the IPO game by allocating to one of its tiny incubator funds a relatively large portion of a hot IPO, potentially supercharging the fund’s returns.

The good news is that the US Securities and Exchange Commission (SEC) has recognized the inadequate disclosure inherent in such practices and has taken some preventive action. The SEC levied fines against both the Van Kampen Growth Fund (a unit of Morgan Stanley Dean Witter) and Dreyfus for unfairly playing the IPO game.

Front Running

Front running is a method fund families can use to enhance the short-term returns generated by one of their new small-cap funds. First, the new fund buys shares of stocks that have low market capitalizations (and thus tend to be inexpensive) and limited liquidity (i.e., the stocks are in limited supply). Next, the other (larger) funds within the same family pile in and buy

more shares. Because of the limited supplies, they don’t have to buy many to drive prices up significantly. Returns of the new fund that bought the stocks in advance begin to look very attractive, with limited impact on the larger funds in the family.

Selection Bias

Selection bias occurs when fund families spend advertising dollars to promote only their top-performing funds. Does selecting funds based on such advertisements help the investor actually achieve high returns?

Prem C. Jain of Tulane University and Joanna Shuang Wu of the University of Rochester examined the performance of 294 US equity mutual funds that advertised in *Barron’s* or *Money* magazines.² They measured performance one year prior to the first advertisement date and one year after. The average one-year pre-advertised return was almost 6 percent higher than the return of comparable funds, and 1.8 percent above the return of the S&P 500. However, during the post-ad period, the same funds returned 0.8 percent below the return of all comparable funds and underperformed the S&P 500 by almost 8 percent per annum. The study also found that advertised funds attracted significantly more investments than similar funds.

Behold, Passive Management

Through such reporting biases, investors are bombarded with temptations to pursue yesterday’s stellar returns, often with a less-than-sporting chance to actually achieve them. The best way to avoid biases is to build your portfolio based on passive investing, an approach that inherently focuses on maximizing future returns rather than seeking to manipulate yesterday’s news.

¹ *Wall Street Journal*, April 4, 1997.

² *Journal of Finance*, April 2000.

Luck of the Draw

Bonne chance, buena suerta, good luck. Recognizing that life is filled with lucky and unlucky breaks, every culture is filled with ways to wish someone well on uncertain journeys. Every so often, someone will respond, “Hey, it’s not luck, it’s skill!” In investing, knowing the difference between luck and skill can make all the difference in achieving one’s financial objectives.

Consider the following lesson. A statistics professor asks everyone in each of her new classes to write down a sequential heads-or-tails outcome of a series of 100 imaginary coin tosses. She then asks one student to flip a real coin and record the actual results. The professor leaves the room until the students have completed the assignment. When she returns, she can almost always immediately differentiate the single real coin toss from all of the fabricated ones.

How does she perform this seemingly magical act? Being familiar with statistics, our professor knows that the outcome with the longest consecutive streak of Hs (heads) or Ts (tails) is likely to be the result of the real flip. When asked which sequence is more likely to occur — HHHHTTTT or HHTHTHTT — a statistician knows that each is equally likely and that both occur with equal regularity. New students, on the other hand, are more likely to construct sequences with fewer long winning streaks, thinking erroneously that more random-looking HHTHTHTT-type sequences are more common.

Researchers have observed a similar phenomenon for basketball players who are on a hot streak, making several shots in a row. An analysis demonstrated that such hot

streaks are likely random — similar to flipping several heads in a row. The study indicated, “The odds that a player will make or miss the basket will roughly conform to his or her overall long-term average.”¹

Applying these observations to the financial world, overreacting to what may seem like patterns but actually are random strokes of luck can and often does lead to poor investment decisions. We explain in “Within the Eye of the Beholder” (at left) how tempting it is for investors to buy shares of funds that are on winning streaks, believing or hoping that the performance will continue (or selling funds that are currently losing). In fact, such winning streaks are more likely the result of luck, or worse, reporting biases that make returns appear larger than life in the rearview mirror.

In his book, *A Random Walk Down Wall Street*, Burton G. Malkiel tested whether an investor could outperform the market by choosing “hot” funds. He analyzed the likely success of choosing the top 10, 20, 30 or more funds, based on their previous

12-month performance, with a switch one year later to the new top performers. Such a strategy produced results that were below the average mutual fund as well as the S&P 500 Index.

After studying the performance of mutual funds back to 1962, Mark Carhart of Goldman Sachs Asset Management reached a similar conclusion. His data indicated performers in the top 10 percent in any one year were more likely to fall to the bottom 10 percent than to repeat their success.²

One way investors can avoid the error of confusing luck with skill is to carefully analyze every seeming pattern. Using the coin-toss analogy, five consecutive coin tosses that all come up heads can easily be considered purely random. But if 95 of 100 coin tosses all come up heads, you might suspect the legitimacy of your coin.

¹ Gary Belsky and Thomas Gilovich, *Why Smart People Make Big Money Mistakes*, © Simon & Schuster, 1999.

² *New York Times*, April 4, 1999.



de•fine \di-ˈfin\ vb de•fined; de•fin•ing [ME, fr. MF & L; MF definer, fr. L. definire, fr. de-+ finire to limit, end, fr. finis boundary, end] vt (14c)

Small-Cap and Micro-Cap Stocks — Small-cap and micro-cap stocks are characterized by a small (small-cap) or even smaller (micro-cap) “market capitalization,” determined by multiplying the number of shares available by the market price per share. In our passive investing environment, precise definitions vary relative to overall market cap values. Currently, stocks with less than \$1.8 billion in market cap fall into the small-cap asset class, while stocks with less than \$761 million are considered micro-cap stocks. Stocks that begin at \$11.2 billion market cap are considered to be large-cap stocks. By including these asset classes (along with value, growth and international components), the investor can build a more diversified portfolio that is tailored to his or her ability and willingness to accept risk and its related expected rewards.



In "Within the Eye of the Beholder," we discuss how survivorship bias can make returns seem larger than life. How common is it for fund families to close poorly performing funds, and how prevalent is the behavior today? See for yourself.

Questions:

1. What year holds the record for mutual fund closings?

- a. 1979
- b. 1984
- c. 1998
- d. 2000

2. How many funds were closed in that record year?

- a. 55
- b. 112
- c. 225
- d. 486

Answers:

1. According to an April 11 2001 article in the *St. Louis Post-Dispatch*, the practice of "disappearing" poorly performing funds is as frequent today as ever. A report by Wiesenberger/Thomson Financial of Rockville, Maryland observed that the year (d) 2000 held the record for the number of mutual funds shut down (with 2001 yet to be measured).
2. The report noted that (c) 225 funds were closed in 2000, barely beating 1998 when 222 funds shut down. Having closed 23 funds, Dreyfus Corporation, a unit of Mellon Financial Corp., received the dubious distinction of having liquidated the most.

S taying Power (Cont.)

Buy and Sell Sparingly

After you've formed your investment plan and built your diversified and tax-efficient portfolio, the biggest favor you can do for your investments is to leave them alone. Rather than chasing the latest popular investment fads, we advise that you buy when you have funds available and sell when you need the funds for expenditures (or as needed for special tax-management purposes). Other than that, take a look at your portfolio periodically (perhaps annually) with your investment advisor. Have him or her help you rebalance as needed to maintain your original objectives.

Over time, the value of each asset class will change by a different percentage due to performance variances. Rebalancing forces you to buy low and sell high as you sell your recent outperforming (overweight) asset classes and you purchase recent underperforming (underweight) asset classes. When your investment advisor helps you restore your portfolio to its original asset allocations and risk profile, he or she takes numerous issues into account, such as the degree of variance, potential transaction costs, tax implications and the most appropriate source for the necessary funds.

¹ *American Economic Review*, May 1991.

² David Blitzer, *Outpacing the Pros*, ©McGraw-Hill, 2001.

Our Basic Tenets

Our objective is to design portfolios using passive asset class funds that maximize investors' returns within their tolerance for risk. Here is what sets us apart:

- ▲ Fee-only investment management
- ▲ A disciplined investment strategy
- ▲ Access to institutional no-load passive asset class funds

- ▲ An academic Nobel Prize-winning investment approach
- ▲ Continued access to academic research
- ▲ A tax-efficient focus, with valuable tax and estate-planning ideas
- ▲ Risk tolerance assessment
- ▲ Periodic portfolio rebalancing
- ▲ Regular communications and state-of-the-art reporting
- ▲ MOST IMPORTANT ...
A TRUSTED ADVISOR RELATIONSHIP