

January 2001

The World Turned Upside Down

The British band played "The World Turned Upside Down" as their soldiers, under the command of Lord Cornwallis, surrendered their arms to General Washington's army at Yorktown, ending the American Revolution. In the early 20th century, revolutionary composers abandoned the traditional 8-note harmonic scale for a new, atonal, 12-note scale, disregarding anything that would sound to us like a melody. Their rules dictated that the composer's initial ordering of the twelve tones be maintained, even if played upside down and backward.

Our upside down musical musings were sparked because last year's financial markets inverted the expectations of many investors. Enclosed is our annual listing of the best performing asset among large stocks, small stocks, foreign stocks and bonds. Bonds, unloved a year ago, were by far the best performing of the four assets and the only one with a positive return on the year.

"The whole history of civilization is strewn with creeds and institutions that were invaluable at first, and deadly afterwards."
-- Walter Bagehot

Our listing helps us again remember that we often know less than we think we do. For example, if you were making predictions in January 1995, you would probably have advised steering clear of large U.S. stocks, which had been the best performing asset in only one of the previous 29 years. Their subsequent four year string of besting the alternatives was snapped in 1999, when foreign stocks were best. As surprising as last year's dominance by bonds may seem, they have been the best performers almost twice as often as large US stocks. The enclosed table illustrates that once a "trend" of superior performance is discoverable, it may be about to disappear. Our diversified approach, maintaining a disciplined balance instead of trying to predict the future, is illustrated in the two columns on the right.

To further illustrate our point, let's engage in a thought experiment with five real-world mutual funds: Janus Twenty, ProFunds UltraOTC and Vanguard's S&P 500, value and bond index funds. Assume we can choose our investments on December 31, 1998 and we have perfect vision one year into the future. In the table on the next page, cover up everything but the fund names and the 1999 returns. Janus Twenty was a lead sled dog of the new era technology boom, focusing on large growth companies. If you wanted something even more zesty, the ProFunds UltraOTC fund attempts to provide twice the daily return of the technology-laden Nasdaq 100 index. By early 2000, \$1 invested in this fund on our starting date was worth more than \$4. The Vanguard S&P 500 index fund was very popular and had a good 1999, just not as exciting as investments more

tilted towards technology. The Vanguard value and bond funds were ignored in 1998 – in a bull market, nobody wants to own bonds, and the value index is full of old-economy, old-era, smokestack dinosaurs.

Fund	1999 Total Return	2000 Total Return	2-Year Total Return
Janus Twenty	64.90 %	-32.42 %	11.45 %
ProFunds UltraOTC	233.26 %	-73.70 %	-12.36 %
Vanguard Index 500	21.07 %	-9.06 %	10.10 %
Vanguard Total Bond Market	-0.76 %	11.39 %	10.55 %
Vanguard Index Value	12.57 %	6.08 %	19.41 %

Now uncover the performance of the funds for the year 2000. OK, you might have expected a little drop-off from those outstanding 1999 returns, but you were still better off with more aggressive investments, right? After tripling your money in the UltraOTC fund, you can endure at least a couple of down years like 2000, right? Now uncover the performance for the two years combined.

"All the misfortunes of men derive from one single thing, which is their inability to be at ease in a room at home."—Blaise Pascal

Investors who bought Janus Twenty at the end of 1998 did only slightly better than if they had left their money in bonds. Since the fund increased in size from \$15.8 billion in 1998 to \$36.9 billion at the end of 1999, many of the fund's investors were not that lucky in their timing. The S&P 500 did worse than bonds, and the go-for-the-gusto investors in the UltraOTC fund are underwater. In a revenge of the dinosaurs, the old-economy value index did much better than the more exciting investments. According to Morningstar, the three-year average annual return for the average growth and income mutual fund (large U.S. stocks), the average small company fund and the average foreign stock fund were 9.43, 9.88 and 9.82 percent, respectively. For this, you are supposed to stay up nights trying to outsmart everyone?

After the whackiness of the atonal school, music saw the resurgence of the neo-classical school, reverting back to traditional symphonic form and harmony. The technology bubble seems to have preceded a resurgence of traditional, value-oriented investing. If your investments have seemed a bit atonal lately and you would like help in developing a disciplined, classical perspective in your investment program, contact us.