

February 1998

Dionne Warwick Phone Home

Late night cable TV channel surfers over the past few years are familiar with ads and infomercials, hosted by former singing sensation Dionne Warwick, for the “Psychic Friends’ Network.” If you join the “network,” you pay to telephone a “psychic friend” who chats with you for a bit and then tells your fortune. Topics suggested by the advertisements include the big two, love and money, but presumably you can ask about anything. Since anyone even remotely connected with investment management is generally considered to be in the fortune telling business, we considered it our professional obligation to monitor these infomercials in case a caller ever asked about the stock market.

***The “Psychic Friends’ Network
filed for bankruptcy – shouldn’t
they have seen that coming?***

Alas, the callers on the show always seem to be more interested in the lottery or office romance. Further insight into the network is provided by the come-on that the first three minutes are free. Since an efficient “psychic friend” easily could answer our questions in three minutes with time to spare, we could only conclude that, in practice, the “network” was a waste of time as well as money. Imagine our disappointment when we recently read that the corporation that created the ads filed for bankruptcy. Shouldn’t they have seen that coming?

The “network’s” financial trouble shows the difficulty of predicting the future. Further evidence is provided by the enclosed update of our asset allocation chart showing the performance of four different types of assets over each of the past 32 years. The first four columns show the performance of large company stocks, small company stocks, foreign stocks and bonds. The last two columns show the performance of aggressive and balanced portfolios mixing the four assets. The best performing asset each year has a box around it.

While much of the financial media now seems willing to predict the future by assuming that buying large U.S. “index” stocks is an automatic road to wealth, prior to 1995 large company stocks were the best performer only once in 29 years. Each of small company stocks and foreign stocks were the best performer 10 times, and bonds were the best 8 times. Even the “psychic friends” were doing something more complicated than simply extrapolating very recent history. The recent run by large company stocks is unprecedented. Various theories have been put forward to explain this performance, but we do not believe the dominance of large company stocks is permanent. If the asset allocation chart tells us anything, it is that each asset class has its season.

At the bottom of the chart are the overall return and risk profiles for the four asset classes and the two combination portfolios. The portfolios show quite good returns with substantially less risk than the three single equity types. We believe this shows the benefits of asset allocation. When the most widely reported asset is also the dominant recent performer, and when every pundit is preaching the virtues of being 100 percent invested in large company stocks, the long-term wisdom of asset allocation (mixing assets to get a good return with much less volatility) can get lost.

Don't take investment advice from somebody promising 30 percent annual returns, even if they aren't wearing funny hats.

Another example of the difficulty of predicting the future is provided by the Motley Fools and their stock market recommendations on the internet and America OnLine. You may have seen the "Fools" on television, wearing jester's hats and touting their favorite stocks. In our May 1996 newsletter, we criticized the Fools for promising 30 percent annual returns, about 50 percent higher than the top performing mutual fund (out of the thousands in our database) over the previous 15 years during one of the biggest bull markets in U.S. history.

The Fools sarcastically refer to anyone in the investment management industry as "The Wise." Well, as one of "The Wise," we slavishly look at the facts. The recent facts regarding the Fools are provided by Mark Hulbert's column in the February 23 issue of *Forbes*. Of the two model portfolios the Fools still talk about, one has beaten the market since its August 1994 inception, while the other has underperformed the market by about the same amount on an annualized basis. What the Fools don't tell you, however, is that they "closed" (stopped reporting on) two other model portfolios that lost money, one of which lost more than 50 percent. Hiding the bad performance of certain accounts is just the kind of action that the Fools (correctly) complain about in others. Even the one "open" model portfolio which supposedly made money since inception in August 1994 is down 20 percent since we first mentioned the Fools in our newsletter, during which time the overall U.S. market gained 40 percent. The gain prior to May 1996 primarily came from just two stock picks – hardly enough of a sample to make us believe the Fools are really superior investors. Maybe we are missing something, but where are those amazing high annual returns that are supposed to result from following the Fools?

Following the advice of anyone promising 30 percent annual returns, even if they don't wear funny hats, is really not much smarter than phoning Ms. Warwick to ask about your love life. Predicting the future is difficult, even for us. We prefer to rely upon the lessons of history, like the enclosed asset allocation chart, and trust our future to a diversified, rational, long-term investment program. If this makes sense to you, contact us.