SIGMA
Investment Management Company
Knowledge plus Discipline

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"Many Shall Be Restored That Are Now Fallen, and Many Shall Fall That Are Now In Honor"

In 1999 technology was the primary driver of U.S. stock market performance. The Standard & Poor's 500 index had a total return of 21.1 percent, but only 7.3 percent without technology stocks. The median stock in the index was up only 3.5 percent. In response to this performance, January 2000 saw a record for net mutual fund inflows of $28 billion. More than that total amount went into technology-heavy sector and aggressive growth funds, meaning that all other types of mutual funds taken together had net redemptions. Investors chase past performance -- but is this a good idea? And how does the financial services industry take advantage of this tendency?

Investors need advisers, not enablers.

The Economist considered this question recently by comparing the results of two hypothetical investors, one who invests each January in the previous year's best performing asset and the other who bought the previous year's worst performing asset. Over the past 100 years, the chaser of returns wound up with less than half the money accumulated by the contrarian investor. For the record, we're not suggesting either of those extreme strategies. Unfortunately, though, it is psychologically difficult to buy underperforming assets and easy to buy past winners of the performance sweepstakes. The financial services industry tends to capitalize on this weakness by making the easy sale (that produces low returns) rather than the hard sale (that produces higher returns). We recently came across an adviser touting himself as a technology expert, claiming outrageously high client returns by focusing on the "new era" sector. The same adviser wrote a column last June, expressing great suspicion of the technology sector and advocating a value oriented approach to investing. So which is it? Sellers of financial products tend to be chameleons, pretending they were always selling whatever worked in the recent past.

At the end of 1999, we got a cold call from a broker claiming that he had called us before to recommend Qualcomm. Qualcomm stock had a pretty good year in 1999, rising 2,619 percent on an 18 percent rise in revenues and a 72 percent increase in earnings per share. But back at the end of 1998, Qualcomm stock sold at a lower price than it had in September 1995 while the S&P 500 more than doubled. How many investors contentedly held a declining stock during one of the biggest bull market runs in history? After the rise, analysts loved Qualcomm and a lot of money managers pretended they'd liked it (and owned it) all along. We're so innocent, we still are *shocked* that the broker wanted to start a professional relationship based upon an obvious bald-faced lie. (By the way, Qualcomm is down 40 percent this year.)

George Kelly, the Morgan Stanley analyst following Cisco Systems, was recently quoted in *The Wall Street Journal* on his method of analyzing tech stocks. Mr. Kelly stated:

"We have to accept the facts of life. If investors want to be in these high-growth companies, we are just trying to take what they are willing to pay and translate it into a target price and therefore a stock recommendation."

There's the "new era" of investing in a nutshell -- stock prices are estimated solely on expectations that a greater fool will pay a higher price, completely unhinged from any notion of the value of the underlying business.

Analysts now look outward at investor appetites rather than inward at the companies they claim to be analyzing.

Another glimpse of the new era comes from Chip Morris, the manager of the T. Rowe Price Science and Technology fund, the largest technology specialty fund. Mr. Morris's tenure is more than three times longer than the average technology fund manager. Thus, we were chilled to read his quote in the December 27, 1999 issue of *Forbes:*

"There are not a lot of people looking to apply true practical measures of valuation in this marketplace because it has proven to only detract from performance…Nobody in this business for longer than last year would look at what's happened over the last year and say it's normal…. We have a choice to make, which is: Do you play in an irrational game or do you choose to do something else? We ask ourselves that every day. But we are a sector fund, and our fundholders expect us to be relatively fully invested; that's just the way it goes…. There ain't nothing out there that can justify [the S&P 500's] valuation in the current marketplace -- with a few notable exceptions. We do the best job we can given the current environment. Everyone's playing the same game. Just hope it doesn't end. When it does, it will end miserably."

This is more like a note to the outside world from a hostage than an interview with the confident manager of a successful mutual fund invested in the "right" industry.

Our newsletter title is from *Ars Poetica* by the Roman poet Horace. We find his notion to be marvelously apt to investing -- the way investors think of a company or sector today is likely to be different tomorrow, and your investment program better take that into account. We believe this argues against concentration in any one type of asset or industry sector, no matter how well it's done recently and how much the "analysts" love it. You should also be wary of advisers who are really enablers -- selling past performance and claiming hindsight genius. If your investment plan needs a genius to work, you need a better plan. If this makes sense to you, contact us.