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Seven Old Rules for the New-Era Market

(Editor's Note -- This month's newsletter is adapted from a September 14 speech by Bill Berg, Sigma's president, in San Diego at the 12th Annual Trust Meeting of the California Banker's Association. While the speech was directed at investment professionals and bank trust officers, the message is applicable to all investors.)

This is a new era. Technology is transforming our economy, just as it did when canals were being built in the early 19th century and railroads were being built in the middle and late 19th century. In the 20th century, we saw a new era when electrification brought light, radio brought mass audiences and automobiles brought mobility in the 1920's. Later this century, airplanes, medical advances, the transistor and the computer changed the way we live our lives.

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Stock market bears questioning the existence of the new economy are missing the point. The appropriate question, from an investment standpoint, is not if it's a new era, but whether it's a new investment world. We have a new economy, but we remain stuck with ourselves -- the same old people, subject to the same old emotions of greed and fear. Stock market bulls claim investors are now steely-nerved, immune to market declines, buying every dip and holding stocks for the "long run." They have a belief in the perfectibility of the human race that hasn't been seen since the fall of communism.

Count me among the believers in the new era but as a skeptic on the transformation of human psychology. It's a wonderful theory, but I run into too many actual people in practice. Investors now tend to do what they have always done -- chase performance. Chasing prior returns is a losing strategy, but it is emotionally easy to do. In contrast, buying something valuable but with poor recent performance is emotionally hard. The financial services industry capitalizes on these tendencies by making the easy sale (that produces low returns) as opposed to the hard sale (that produces higher returns). When you see an ad for a mutual fund, they tout recent returns, not a long-term, disciplined process. Market analysts tend to give higher ratings to stocks that have already gone up than to stocks that have gone down.

Since the market has gone up for so long, it has been emotionally easy to be an aggressive investor, regardless of your individual situation. In fact, the media and the financial services industry seem to question the intelligence of anyone not fully invested in the stock market. Given current market valuations, however, aggressive investors in today's stock market are consciously or unconsciously betting that this is a new *investment* era, not just a new

technological era. Predicting new investment eras is a low probability event, just like predicting stock market crashes. I like to think of this bet in terms of the work of Blaise Pascal, the 17th century French mathematician. Pascal said that each of us is wittingly or unwittingly making a wager on the existence of a Supreme Being in the way we live our lives. Pascal suggested focusing on the risks of being wrong. A bet on the existence of a Supreme Being risks the opportunity cost of the time spent in church, synagogue or mosque. If you bet on there not being a Supreme Being and are wrong, you suffer eternal damnation.

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Without commenting on the theological efficacy of Pascal's analysis, we believe it provides a framework for thinking about managing client money. Our typical clients are baby boom professionals investing retirement money or entrepreneurs who sold their business. If we bet on our rational disciplined process and are wrong, there is an opportunity cost from being a little too conservative in a buoyant market. If we bet on a new era and are wrong, there are irretrievable portfolio losses for people who don't have the time to recreate their nest egg. We are not mutual fund managers who win by taking risks to be at the top of the performance charts -- we win by keeping our clients following an investment blueprint that makes sense for their unique situation. We cannot forget that we are dealing with real lives, where the pain of loss is usually greater than the pleasure of winning.

Investing mixes the achievement of goals and risk tolerance with a gaming aspect that is emphasized by both the media and many service providers. The gaming aspect also encourages people to latch onto investment styles that may be *au courant* but which are inappropriate for them. We analogize this to dieting -- there are a lot of diets that can make people lose weight, but there are still a lot of obese people around because they cannot stick to the diets. There are a lot of roads to investment success, but if you can't consistently follow the plan, they are worthless. Unfortunately, our brains are naturally wired to make us optimistic at market tops and pessimistic at market bottoms.

We see this recently in continued investor optimism in the face of recent market action. Most investors, egged on by friends, co-workers and the financial media, appear to believe that we continue to be in a rampant bull market. But are we? Ned Davis Research, a leading institutional financial research firm, breaks down publicly traded stocks into 100 industry groups, with each component stock equally weighted. From May 1998 through June 2000, only 26 of the 100 industry groups had positive returns. If these substantial odds against making money aren't depressing enough, consider the list of winners other than the technology-related industries you might expect. Would you have concentrated your bets on advertising, gaming, aluminum, newspaper publishing, water utilities, alcoholic beverages and western electric utilities? Neither would we. Even among technology companies, it seems each day the stock prices of some favorites are devastated for relatively minor disappointing news. It is not as if all technology companies have made investors rich.

Investor sentiment lags market performance. When a bull market has run for a long time, it takes a lot to change pervasively positive investor sentiment. At the beginning of 1973, everyone was convinced they were in a runaway bull market, despite the Dow Jones Industrial Index being at roughly the same level as seven years before in early 1966. People are convinced we are in a very bullish market now, but the odds have been stacked against investors making money since early 1998.

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Once sentiment changes, it does so with a vengeance. Things that seem reasonable in one environment seem idiotic later. Consider sexual harassment law. Behavior regarded as innocent 30 years ago results in termination and litigation now. If we have an extended period of negative stock market returns, how rational will it seem that everyone should be aggressively and fully invested in equities? Won't it seem ludicrous that Joe on the loading dock was supposed to choose the appropriate level of emerging markets exposure in his 401(k) plan?

This kind of change is built into the investing world. The U.S. stock market this century has experienced three extended "super-bull" markets (the one that ended in 1929, the one that ended in the 1960's and the one we are in now), with "super-bear" periods in between. The dominant, transforming investment laws passed this century, the Securities Act of 1933 and the Employee Retirement Income Security Act of 1974 (ERISA), each came into being at the bottom of one of the "super-bear" periods. Investors demand legislation when suffering the pain and fear of a bear market.

Now we are at the opposite end of the cycle. The investing experience of most investors is limited to the period since 1974, during which the Dow Jones Industrial Average has risen from 580 to a high of 11,700, breeding sloppiness in investor respect for risk. So what is an investor to do? Once again, we think of Pascal -- what are the consequences of being wrong? We make no pretense to predicting near-term market movements. The stock market could easily do what most people expect and continue to advance. But what if they are wrong? Consider what happens if we endure an extended period of flat or down markets. Despite our belief in the new era, we believe investors should follow some old era investing rules:

1. Avoid illiquid, speculative investments. Like the swallows to Capistrano, boom times bring promoters of "special" investment products to be sold to overconfident investors. Some of us are old enough to remember the legion of ill-conceived tax shelters from the 1970's and early 1980's. Now, the hot investments are venture capital partnerships and "hedge funds." A recent *Wall Street Journal* article described the young manager of a major university endowment who had 30 percent of the endowment invested in venture capital, far more than the endowment's total investment in the U.S. stock market. He had

gotten rid of all the endowment's value managers and unloaded "underperforming" assets such as bonds. This is a wonderful hindsight portfolio looking back at the last five years. We wonder if the manager or endowment trustees are prepared if there is a repeat of the woeful returns from venture capital in the late 1980's following the bust of the personal computer boom.

In investing, when you're rich it's on paper and when you're poor it's in cash. – Mark Twain

2. Don't emphasize capital gains to the exclusion of income. A significant portion of the return from common stocks this century has come from income, not capital gains. This is easy to forget now that the dividend yield on common stocks is at an unprecedented low. It is also easy to disregard fixed income returns that seem paltry compared to equity returns in a buoyant market. There have been long periods, however, during which "income" returns greatly exceeded returns from investments focused solely on capital gains. For example, from February 1966 to early 1987, a money fund investor had returns superior to those earned by an index investor in the Dow Jones Industrial Average (including reinvested dividends), with a lot fewer Roloids consumed.

3. Make sure you are really diversified. A major investment risk is lack of diversification. Many stockbrokers and investment advisers focus on one particular type of investment and overweight particular stocks or sectors. Even if you own 40 different stocks, if 35 of them are in one industry or sector, you are not really diversified. If a mutual fund family's investment process results in several of its funds (which may be in different objective categories) owning substantial positions in the same stocks, clients may think they are diversified when they are not. Investors in those funds might think they own three or four different funds when they actually own what amounts to the same fund with three or four different names.

4. Avoid single stock portfolio concentrations. One product of a bull market is an increasing number of portfolios that are dominated by a single holding as a result of stock options exercise, sale of a business or inheritance. This results in significant single-company risk that should be diversified away. Unfortunately, selling the single holding is almost always difficult, both emotionally and for tax reasons. We have developed a method of quantifying the risk/reward tradeoff of a concentrated holding compared to a diversified portfolio to help motivate our clients to do the rational thing. Unfortunately, fear of future regret makes selling the single stock difficult, even in non-taxable accounts. The recent market, however, has decimated the stock prices of even market favorites virtually overnight based upon modest earnings disappointments. Once-dominant businesses (e.g. Xerox, Digital Equipment) can see their market position erode over the years.

5. Don't get caught in a single style focus. Because our brains focus on the recent past, it is easy to forget the cycles that give each investment style its day in the sun. Growth has been dominant for a few years, leading portfolios to lean more towards growth stocks, but longer term analysis shows that returns

from value stocks exceed those from growth stocks. Larger company stocks were dominant in the late 1990's, making it easy to forget the commanding return advantage small company stocks enjoyed in the late 1970's and early 1980's. We aren't suggesting that it is easy (or even possible) to predict the next style shift. We are suggesting, however, that we should all be on guard against a natural tendency to be over-weighted in a single style, based upon recent performance, just as it is about to go through a long dry period.

6. "Blue Chips" aren't always the answer. In periods of uncertainty, many investors retreat to the security of large, blue chip companies. This does not provide any guarantee against a decline in wealth, however. After a speculative, technology-driven market was devastated in the 1969-70 bear market, investors flocked to the "nifty fifty," a set of consistently growing, dominant companies. In the subsequent bear market in 1973-74, many of these leading companies saw the price of their stocks decline 80 or even 90 percent. Investors who neglected diversification to buy only these "safe" stocks saw their portfolios destroyed.

In the 1970's, investors neglected diversification to buy only "safe" stocks, and saw their portfolios decimated.

Current apologists for big stocks point out that continuing to hold a portfolio of the "nifty fifty" would have caught up to the S&P 500 in the early 1990's. We're not questioning their math, just their sense of

realism. To all those investors who lost more than three-quarters of the value of their portfolios and happily held on to "break even" 20 years later, pat yourself on the back. Both of you.

7. Don't forget asset allocation. The concepts of "asset allocation" and the benefit of diversified portfolios were codified in academia in the 1950's and 1960's, but were largely ignored by the investing profession at that time. After the 1969-70 and 1973-74 bear markets, however, it was clear to most institutional investors that their approach to investing in the previous 15 years was flawed. They had thrown smart, motivated, highly educated, hardworking professionals and a lot of computing power (such as it was then) into a "performance" sweepstakes that everyone lost. The resulting anguish, aided by litigation and the passage of ERISA in 1974, pushed them to accept an academic theory that promised a new rational structure with which to approach investing.

Ironically, modern portfolio theory saved the investing profession that had spurned academia for so long. Fiduciaries were given a new sense of their obligations. Investing practitioners had a new theoretical framework to help direct their efforts on behalf of clients. After the dark years of the 1970's, modern portfolio theory and asset allocation made possible the recent golden age of the investment industry.

Even more ironic, however, is the increasing disregard for this theoretical framework due to the lure of "easy money" in the current bull market. Broad diversification has given way to "concentrated" portfolios. Applying a consistent long-term approach has given way to a freewheeling, day trading style. The

manager of the largest technology specialty mutual fund states that attempting to apply true, practical measures of valuation has proven to detract from performance. A leading technology analyst from an eminent firm admits that he bases his recommendations on his estimation of what investors are willing to pay, unhinged from any notion of the value of the underlying business.

It is most easy to be courageous when there is no sense of danger.

A prominent market strategist from another leading firm recently wrote a piece titled “Does Asset Allocation Matter Any More?” and concludes that it does not. He recommends concentrating portfolios in the highly priced, large growth stocks that have done well in the past few years. He states that, for investors who want to “maximize capital appreciation over a multiyear period, and for whom short-term volatility is tolerable, asset allocation should have little appeal.” This conclusion is based mainly on recent high equity returns, low current bond yields and the assumption that investors are more impervious to risk than they used to be. But asset allocation theory never claimed that equity returns weren’t higher in the long run than cash or bonds. It did, however, question the wisdom of concentrating on one investing style (e.g. the large growth approach of the strategist) and the “tolerance” or fortitude of investors during the periods of “short-term volatility.”

It is easy to be courageous when there is no sense of danger. It is easy to tolerate volatility when it is all on the upside. The periods of greatest investor courage this century were at the peaks of the bull markets of the 1920’s and 1960’s, at the times investors were in the greatest danger. Both periods were correctly seen contemporaneously as “new eras” for technology and the economy. In both periods, investors were thought to possess a new sophistication, making them capable of withstanding “short term volatility” or whatever the euphemism was for severe market declines. After both periods, portfolio values were shattered and investors, suddenly not capable of withstanding downside “short term volatility,” became fearful. Or maybe they just sold what was left in their accounts because they needed the money.

The old rules of investor wisdom early in the 20th century were given new respect during the Great Depression and, in more rigorous theoretical form, after the market debacle of the early 1970’s. New economic eras come and go. In the two completed super-bull/bear stock market cycles this century, however, the “old” investing rules are two for two. Pascal would know better than to bet against them in round three, and you should too.