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Investors are Born Free, and Everywhere they Are In the Chains of a Broker Mentality

Do “real men” buy stocks? The Neanderthal phraseology of the question is not as misguided as the notion behind it – that mutual funds are at best the investment medium of the proletariat and at worst the refuge of those too gutless to invest “on their own.” For some, bragging about being an early investor in Microsoft or Starbucks generates the same testosterone levels as buying the new hot car or dating a Victoria’s Secret model. Perhaps it is time to explain why we focus on mutual funds.

In the “retail” world, Ozzie and Harriet entrust their money to someone with whom Ozzie happened to play golf.

Until the past decade, there were two investment worlds. In the first, large pension funds agree upon an investment “blueprint” setting forth the returns they wish to generate, the risks they are willing to take, and the asset classes in which they invest. For each asset class or style, they conduct a search to select the best available manager or managers for that type of investment. The plan trustees, actuaries and consultants monitor the performance of the managers versus their peer groups and make adjustments as necessary.

In the second, Ozzie and Harriet “retail” world, Ozzie plays golf with an individual stock manager or broker and then gives him their assets. As a result, Ozzie and Harriet wind up with a jumble of ideas that have more to do with what yields the greatest profit to the service provider than what is appropriate to the investor’s profile. The jumble changes often, however, because that is the only way the broker gets paid. A broker who put all of her clients in Microsoft when it came public would have made them millionaires, but she would have been fired a month after the initial public offering for “lack of production.”

The explosion in the number of mutual funds over the past 15 years means that the first model can be applied to much smaller portfolios. After all, a mutual fund is just a means of accessing the investment skills of a particular portfolio manager. Real-world people can determine their objectives and constraints, select appropriate managers and monitor their performance, just like a large pension fund. You also get:

1. Diversification. You can blend together specialized portfolios in a way that ensures adequate diversification. In contrast, many individual stock portfolios wind up with too few holdings concentrated in too few industries. Even if you hold 25 stocks, if 15 of them are in technology, you’re not diversified.

2. Emotional Advantage. Stocks are bought and held on the basis of emotions. Stock brokers and small investment managers tout stocks on the basis of an emotion-gripping story about the imminent future success of a company. When things start to go bad, they take refuge in the story rather than focussing on new realities. In addition, everyone knows the price at which they bought a stock, which has an enormous influence on the investor's decisions. Unfortunately, the stock doesn't know you own it or the price you paid. Emotions lead investors in individual stocks to hold onto their mistakes, vainly hoping they can "get even."

Most devastating is the necessary pretense – when was the last time you heard a stock manager or broker say "I don't know?"

In contrast, mutual funds are so boring that nobody is likely to fall in love with them or remember the price they paid. Decisions to buy or sell a fund are much less likely to be clouded by emotions. All mutual funds do is achieve your financial goals. Taking emotions out of the equation is a big step towards investment success. Serenity is good.

3. Lack of Pretense. Perhaps the primary flaw of the old "retail" individual stock model is that it relies upon pretense. Do you really believe that you, your broker or a local investment manager knows more about General Motors than the hundreds of analysts whose only job is to follow the auto industry? On what basis does a manager picking individual stocks across many industries and investment types believe they have an "edge?" On the other hand, when was that last time you heard an individual stock manager or broker say "I don't know?"

At Sigma, we are blissfully free of the pretense of knowing more than the efficient free market about the prospects for success of the new Japanese economic stimulus, the effect of the Euro-currency on individual Continental stock markets, or the potential impact of prospective environmental legislation on the U.S. auto industry. The successful, specialized managers we select for our client portfolios in each of these areas are much more likely to make the correct decisions than we are, or any other person without the requisite specialized knowledge.

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