SIGMA
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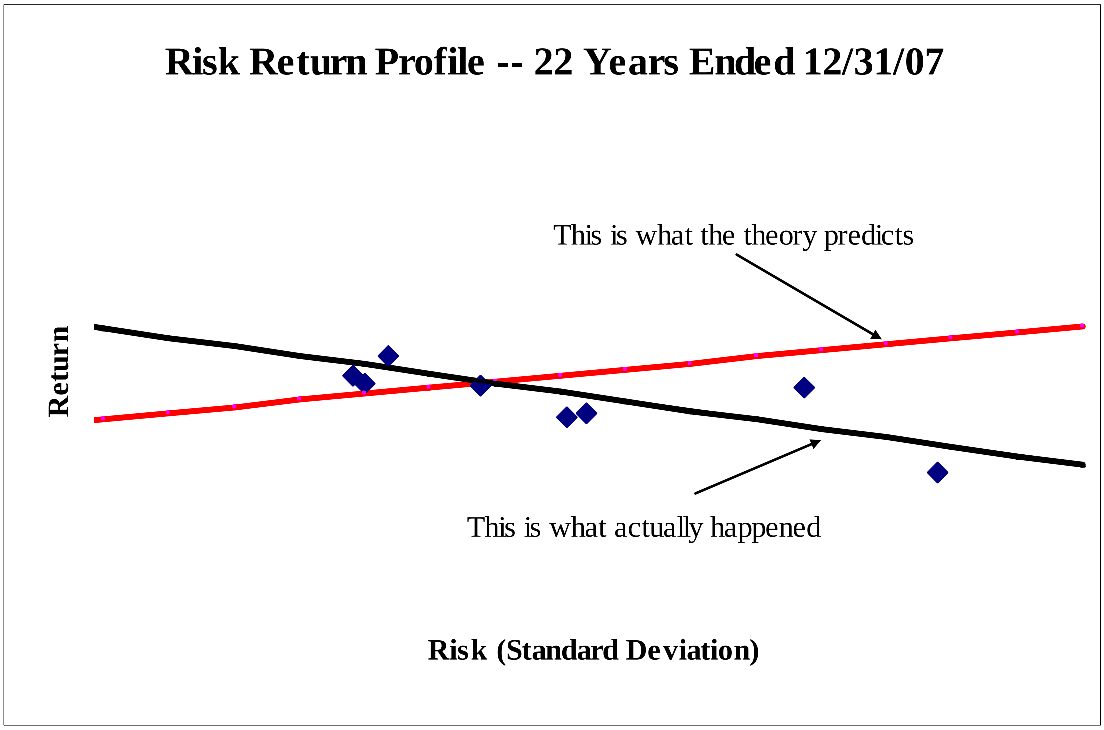
The Invisible Emperor?

In *The Emperor's New Clothes,* by Hans Christian Andersen, rogues swindle the vain emperor by pretending to tailor a new suit made of a special cloth invisible to those who are stupid or otherwise unfit. The emperor's sycophantic court followers and his fearful subjects assure him that his new clothes are magnificent until a child speaks the embarrassing truth that the emperor is naked. This is a wonderful parable of investing, in which an ever-present peril is groupthink.

Starting in the 1950s and accelerating in the 1960s, there was rising academic interest in dissecting the workings of the financial markets. This was largely ignored on Wall Street -- in the bull market of the swinging 1960s, everyone was having too much fun to pay attention to academic scribblers. People who believe they are getting rich tend to lack curiosity, and they certainly are not in search of new theories. The subsequent bear markets, multiple brokerage firm failures and threats of regulation, however, focused the attention of investors.

Wall Street found help in the form of Modern Portfolio Theory (MPT), the product of the work in academia. While the gunslinger portfolio managers of the 1960s just chased stocks in an undisciplined manner, MPT, in the dark days of the 1970s, granted respectability to investing and provided a structure for, if not a shield against, regulation. Wall Street quickly caught on that it could use MPT to sell product, and investment firms added egghead PhDs to their staffs; before long, the pitch of any "sophisticated" stockbroker was bubbling over with talk of efficient frontiers, algorithms, portfolio optimizers and the like, the new MPT lingo providing a patina of respectability. The basic idea behind MPT sounds reasonable enough. Stripped of the Greek letters and the quadratic utility functions, one of the fundamental ideas is that the more risk you intelligently assume in investing, the more return you should receive. High-risk investments are not for everyone, and those seeking safety should pay for the privilege.

But does it work? In the chart on the next page, we show eight diversified indexes of U.S. stocks relating to investment size and style (e.g. large growth stocks or small value stocks) plotted on a risk/reward continuum over the past 22 years. Given the precepts of MPT, you would expect that the indexes with higher risk would also have the highest returns.



The regression line, however, shows the opposite – the lower the risk, the higher the return and vice versa. Now, this is not the whole story: You can get a more benign picture by adding fixed income securities, foreign stocks and the like. And maybe 22 years is not long enough for the theory to manifest itself in practice (past performance not guaranteeing future results), although this is no comfort to the retiree using MPT to guide her investments – the only thing that matters to her is the period she actually lives through. In large part, however, it appears the supposedly sophisticated theory, at least as Wall Street applies it to sell products, presents a curious inversion of the Hans Christen Andersen story. In this case, the clothes (the mathematics and other theoretical constructs of MPT) really are beautiful, but, perhaps the result of our childlike naïveté in wanting theory to work in practice, we have some trouble seeing the emperor.

> ***"However beautiful the strategy, you should occasionally look at the results."***
> – Winston Churchill

The enclosed sheet lists the returns from four major asset classes: large stocks, small stocks, foreign stocks and bonds, with a box around the best performer each of the past 42 years. This is index data, with no effect from timing, security selection, costs or taxes. On the right are aggressive and balanced diversified portfolios mixing the assets. Investing in the balanced mix (60 percent in stocks and 40 percent in bonds) has had a return similar to the S&P 500 index with substantially less risk. You will never hear that from the sycophantic courtiers on Wall Street, though.

At Sigma, we are well versed in finance theory, but we believe it is even more important to have common sense. Any theory that is unstable upon confronting reality is not helpful in investing your portfolio. If you would like advice combining theory and reality, based on evidence, call us at (503) 419-3938 or contact us through www.sigmainvestment.com.