The Index Investor

Why Pay More for Less?

Model Portfolios Performance Update

Clashing expectations and deep uncertainty about the sustainability of current valuation levels was fully in evidence throughout the U.S. equity markets in February. Over the past five years, large cap have been enjoyed rates of return substantially above the historical average. Consider the following: between 1926 and 1994, the average annual return on the S&P 500 was 12.35%, with a standard deviation of 22.30%. Between 1995 and 1999, the average annual return has been a whopping 29.78%, with a standard deviation of only 17.80%. Moreover, most of these above average returns have been driven by increases in the market price/earnings multiple, rather than by substantial increases from earnings growth. With market valuation multiples now at altitudes where oxygen masks are typically required, and the prospects for rapid earnings growth dimming with every increase in interest rates and oil prices, investors have justifiably become a bit unsettled.

Unfortunately, having come to expect high rates of return, and perhaps even to believe in their ability to beat their index of choice by picking individual stocks, many of these investors are now looking for the next hot sector, rather than questioning their basic decisions about asset allocation, cost and tax management
The results of these developments can be seen in the divergent performances turned in by different sectors of the U.S. equity markets last month. While large cap growth was down by 4.7% year to date, and large cap value was down by 9.3%, midcaps were up 4.0%, and small cap value was up by 14.5%.

For those of us who have focused rather more of our energy on the latter questions, this year is off to a reasonably good start. In particular, the logic of having the Oppenheimer Real Asset fund in our model portfolios has become apparent. Its negative correlation with most other asset classes is evidenced by its 13.7% year to date return, which has underpinned the benchmark beating performance of our high, medium, and low risk portfolios.

By way of comparison, our decision not to include this asset class in our target return portfolios has undoubtedly held back their performance. Nevertheless, their relative performance ranking is still on target.

The New Fortune Indexes

Fortune has recently introduced two new indices, the first based on the Fortune 500, and second based on a group of "new economy" companies they refer to as the e-50. The first is "designed to measure the performance of the biggest American businesses", while the latter is intended to "best capture the scope of the internet revolution."

Here is the way they explained their decision to enter the indexing business: "Everyone knows that the old [indexing] tools aren't hip enough for the new century. Not only is the Dow way to tiny (a mere 30 stocks), but it is also weighed down by the remnants of industrial America, making it no longer relevant to huge swaths of the stock market. Even the S&P 500 doesn't fully reflect the performance of America's biggest companies, and it definitely doesn't get the cutting-edge internet stocks. While more than a dozen internet-only indexes have sprouted – TheStreet.com's DOT index and the Goldman Sachs internet index, to name just two – none seem up to the task of measuring the broad internet economy."

Let's take a quick look at how these two indexes compare to their more familiar competitors. According to Fortune, the main difference between the Fortune 500 Index and the S&P is that the former "ranks companies solely by their size" while the latter "is based on subjective decisions and includes foreigners like Unilever and Royal Dutch/Shell." For this reason, the F500 includes a number of companies that aren't in the S&P, including Estee Lauder, Starwood Hotels, Continental Airlines, and Avista. Both indexes are constructed using market capitalization weights for the companies they include. In terms of performance, Fortune claims that their index has outperformed the S&P over the past four years, gaining 25.8% annually versus 24.3%. Return, however, is but half the equation; data on relative riskiness of the two indexes is not available.

The e-50 is a more interesting index. To begin with, it attempts to capture “the scope of the internet revolution” by including four types of companies: pure play e-commerce companies (e.g., Yahoo); net software and service companies (e.g., Cisco); and net communication companies (e.g., Qwest). In constructing the index, it then attempts to adjust these companies’ market capitalization weights based on how much of their revenue comes from internet related activities. Finally, it sets a limit so that no individual stock can account for more than 10 percent of the index. In Fortune’s view, this makes the index significantly different from both the Nasdaq 100 (where, for example, Cisco, Microsoft and Intel have a combined weight of 39%, versus just 26% in the e-50) and TheStreet.com’s DOT.

It will be interesting to see if any mutual fund companies launch new products based on either of these indexes. If and when they do, we will provide you with comparisons to other products.

Annual Review of Portfolio Weights

As regular readers know, we have built seven model portfolios with two types of investor in mind. The first type of investor in principally concerned with beating the return on some type of index, while taking on no additional risk. Call this the “competitive type” of investor. With him or her in mind, we have built three model portfolios, called high, medium, and low risk. The objective of the first portfolio is to deliver more return than a benchmark comprised 80% of the S&P 500 index, and 20% of the Lehman Brothers Aggregate Bond Market Index, while taking on no additional risk. The medium risk portfolio’s objective is to deliver more return than a 60% S&P 500/40% Lehman

Aggregate Bond benchmark, while the low risk's objective is to better a 20% S&P 500/80% Lehman Aggregate Bond benchmark.

The second type of investor has a clear understanding of the minimum rate of return he or she must achieve on his/her portfolio to fully fund his/her future liabilities (e.g., for college education and/or retirement). This investor's principal goal is to allocate his/her assets to maximize the probability of achieving this "threshold" or minimum required return, while taking on as little risk as possible. Call this the "cautious type" of investor.

We have reviewed the performance of our model portfolios over the past year, as well as the underlying composition of many indexes. Based on this review, we have decided to keep our recommended portfolio weights unchanged for the next twelve months. Undoubtedly, some people will criticize us for this decision, and wonder why we have not increased our weightings for large cap growth stocks, or even introduced the use of more narrowly defined technology indexes into our model portfolios. Let us explain.

There is an old saying that the way to get rich fast is to concentrate, while the way to get rich slowly is to diversify. All around us, the press is full of stories about people who have successfully done the former. Clearly, if someone had invested all of their assets last year in a company like Qualcomm, they would be much wealthier today. On the other hand, if they had invested all their assets in, for example, e-Toys or iVillage, they would be considerably poorer today. The point is clear – investing a substantial portion of your assets in a single stock can make you both wealthier and poorer very quickly. It is almost inevitable that people who invest this way are going to generate widely varying returns from year to year.

This is clearly not the case for an investor with a well-diversified portfolio of index funds, who can generally count on a steady stream of lower, but far less variable returns (because the returns on the asset classes in the portfolio have low correlations with each other). However, the difference between the two investors comes down to more than a question of emotional preference or personal style. There are also real economic consequences involved. Consider a simple example: Harry the High Flyer and Irving the Indexer both have $100,000 to invest. Harry invests in technology stocks, and earns returns of 25%, (20%) and 42% over the next three years. During the same period, Irving's portfolio returns 17%, 16%, and 15%. Who comes out ahead?

In percentage terms, they end up dead even, as they both have average three-year returns of 16% per year. In wealth terms, however, Harry ends up with $142,000, while Irving ends up with $156,078 – 10% ahead of Harry, Master of the Technology Universe.

Finally, this simple example may be too kind to Harry. Why? Because active investors are particularly exposed to two natural biases that frequently cause human beings to make less than perfectly rational decisions. The first of these has been summed up in the phrase "losing hurts twice as bad as winning feels good" (the fancy name is prospect theory). Because of this bias, we are prone to taking on much more risk when attempting to avoid a loss, and much less risk when it comes to keeping our gains. In investment terms, most active investors have a tendency to ride their losses too long, and take their gains too soon. The problems this causes for one's portfolio are only made worse by our second natural bias: overconfidence. Not only do we ride our losses too long, but we're usually too sure that it's the right thing to do!

This is not to say that Harry was necessarily wrong to take an active approach to investing. Perhaps his future liabilities are all fully funded, and his $100,000 was money he could afford to lose. Perhaps Harry cares more about short-term bragging rights at the club than he does about ensuring his long-term financial security. Or perhaps Harry believed he had access to superior information about the companies in which he invested (and in at least one case, this proved to be true!). Whatever the reasoning behind Harry's choices, Irving's portfolio has created more wealth – and undoubtedly less stress in the process. It is for the Irvings of this world that we created Index Investor, and it is with them we look forward to enjoying the coming year, whatever it may bring.