

THE EDUCATED INVESTOR

Winter 2001

FOCUS
Asset Management Company

Tuition Bill From 2000

If you're new to investing and you aren't sure where to begin, you're not alone.

Step one is to obtain a basic education by reading a few good books on Modern Portfolio Theory and passive investing.

The alternative is to enter the market without guidance, an educational experience that typically results in a much more expensive "tuition bill." In 2000, many investors found themselves receiving costly PhDs on market behavior. Here are some of the lessons learned.

1. Stocks and asset classes do not grow to the sky.

To learn this lesson, one only has to realize the error (and regret) of those who invested heavily in the NASDAQ, which reached its all-time high of 5,048 in March 2000, only to watch it plunge to 2,471 by year-end.

2. Valuations matter over the long run.

Essentially, a stock price must be justified in the long run by its earnings. In March 2000, the NASDAQ traded at a price-to-earnings (P/E) ratio of well over 200. For comparison, not one of the "Nifty Fifty" stocks that had traded at P/E ratios of more than 50 during their heyday in the 1960s had outperformed the market 25 years later.¹

3. "This time it's different" is hardly ever true.

Recent technology investing has been a roller coaster ride, but hardly unprecedented. A *New York Times* article provides

For Your Reading Pleasure

A modest investment in a few books related to passive asset class investing can help you embark upon your investment travels, and hopefully avoid investment travails. Here are some recommended readings for the beginning investor:

- ▲ Larry Swedroe's *The Only Guide to a Winning Investment Strategy You'll Ever Need and What Wall Street Doesn't Want You to Know*
- ▲ Gary Belsky and Thomas Gilovich's *Why Smart People Make Big Money Mistakes*
- ▲ Bill Bernstein's *The Intelligent Asset Allocator*
- ▲ Peter Bernstein's *Capital Ideas*
- ▲ John Bogle's *Bogle on Mutual Funds and Common Sense on Mutual Funds*
- ▲ Burton Malkiel's *A Random Walk Down Wall Street*
- ▲ Bill Schultheis' *The Coffeehouse Investor*

the following example: "Between 1904 and 1908, more than 240 companies entered the nascent automobile business. In 1910 there was a shakeout, and many of those companies went under. The railroads exhibited the same behavior in the 1880s."² Similar examples abound throughout history.

4. You cannot predict future winners based on past success, but you can diversify.

2000 was no exception, as 1999's winning (losing) asset classes provided no predictive advantage. Emerging markets was the best-performing asset class for 1999 and the worst performing asset class in 2000. Conversely, real estate provided disappointing annual returns of -15.4 percent in 1998 and -2 percent in 1999, but was the best performing US asset class in 2000. Without the ability to predict, diversifying your investments is the rational strategy.

5. Regular rebalancing adds even more value.

Investors who were rebalancing their portfolios all along were rewarded in 2000. By restoring their chosen risk profile instead of making predictions, they were simply selling some of their (outperforming) large-cap growth stocks in prior years and buying (previously underperforming) small-cap stocks, value stocks and real estate. They were selling high and buying low.

Continued on page 4

What's Inside?

- ▲ Worldly Investing
- ▲ A Defining Moment
- ▲ Building the Tax-Efficient Portfolio
- ▲ Worth Repeating
- ▲ Investor Tester

Worldly Investing

Many investors avoid investing internationally because they fear disappointment. Following are reasons we believe there is room in almost any portfolio for an international dimension:

Investing internationally can actually reduce overall risk.

Paradoxically, while many investors avoid international as too risky, studies have indicated that adding an international component can actually *reduce* the risk (volatility) of your overall portfolio. This is mostly because international equities have low **Correlation** with domestic equities. (Refer to “A Defining Moment” for more about correlation.) A landmark study on the topic was published in the Fall 1998 issue of the *Journal of Investing*. The study covered a period when the EAFE Index (the European, Australasian and Far East Index) actually underperformed the S&P 500. The study demonstrated that adding international assets to a portfolio, even during a period when they underperformed, resulted in higher portfolio returns and lower risk. It indicated that investors with a 10 percent international allocation had a 98 percent chance of reducing their risk.

As with other asset classes, international holdings can be expected to compensate appropriately for the measure of risk taken.

We’ve also heard it argued that one should avoid investing internationally because the SEC regulatory environment makes the US a safer place to invest. We fully agree that the SEC helps create a safer investment environment domestically. However, to actually benefit from this information, you would have to be among the few who know it. In reality, everyone knows that stocks are riskier wherever regulatory

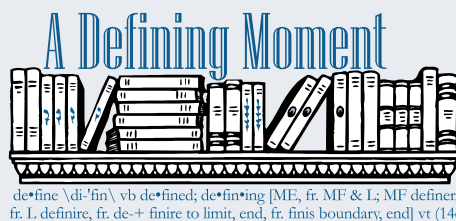
environments are more lax. The markets therefore price for that risk. As compensation, you can expect higher returns over the long run.

We live in a global economy.

If you are a US citizen or resident, it is likely that you have the vast majority of your intellectual capital in the domestic market. Your employment is probably tied to the US economy. You likely own or rent a US residence, which constitutes a significant portion of your assets and/or expenses. If the US dollar value falls, imports will become more expensive and domestic manufacturers will typically raise prices as well. Living will cost more. Allocating part of your portfolio to international asset classes provides an insurance policy against such potential problems. For example, consider

Japanese investors in 1989. Like many US investors today, they may have seen no reason to diversify internationally while their economy boomed, their technology dominated the world and their stock market was outperforming everyone else’s. Yet, as 2000 closed, the Nikkei Index was still down approximately 40 percent from its level of more than 11 years ago.

Further, with the freedom of capital to move around the globe, there is no reason to believe US equities will provide higher long-term returns than international equities. (Even if our economic prospects are better, prices already reflect it.) For the 31-year period 1969-1999, there was virtually no difference between S&P 500 Index and EAFE Index total returns (12.9 percent and 12.8 percent, respectively).



Correlation — In mathematics, correlation is the measure of the linear relationship between two variables. Values can range from +1.00 (perfect positive) to -1.00 (perfect negative) correlation. An example of a strong positive correlation would be stock from two oil companies, both of whose prices increase as oil prices increase. A strong negative correlation might exist between an oil company (that would benefit as oil prices rise) and an airline company (that would benefit as oil prices fall).

Turnover — A fund’s turnover ratio is the measure of its annual trading activity. Higher turnover generally results in more realized gains passed on to investors. Unless the fund is in a tax-deferred account, investors must then pay taxes on those gains, reducing the assets they have to invest. Thus funds with lower turnover are generally more desirable for taxable accounts. Index/passive funds generally have significantly lower turnover than do actively managed funds within comparable asset classes, and thus they are more tax efficient. For example, using Morningstar data, turnover for all actively managed domestic equity funds in 2000 was 118 percent, compared to domestic index fund turnover of 23 percent.

Building the Tax-Efficient Portfolio

As you file your 2000 returns, you are perhaps particularly aware of the enormous impact taxes can have on your final returns. While nobody can wholly eliminate taxes, following are some techniques your investment advisor can use to help you minimize the load:



Implementing a Tax-Efficient Investment Approach

Fortunately for those who adhere to passive asset class investing, the investment approach we recommend is already inherently more tax-efficient than investing in actively managed mutual funds. This is largely due to the higher **Turnover** experienced by the typical actively managed fund. (Refer to “A Defining Moment” for more about turnover.)

Investing in Tax-Managed Investment Vehicles

As public demand for tax-efficient solutions grows, fund families such as Dimensional Fund Advisors, Charles Schwab & Co. and The Vanguard Group are adding passively managed tax-managed funds to

their product menu. By implementing tax management as a specific objective, fund managers anticipate that they can further improve on the inherent tax efficiency of index funds. In addition, Exchange-Traded Funds (ETFs) are relatively new and relatively tax-efficient investment vehicles. Early analysis indicates they might be even more tax efficient than the average index fund, as ETF sponsors expect to be able to minimize capital gains distributions in a way not possible using traditional mutual funds.

Maximizing Tax-Efficient Asset Location

Your investment advisor also can ensure that you hold your most tax-efficient investments within your taxable account(s) and your least tax-efficient investments within your tax-deferred IRA or other retirement account(s). A recent study by the National Bureau of Economic Research determined that investors achieved the greatest wealth by holding *index* equity funds in their taxable accounts and fixed income in their tax-deferred accounts. Such an approach achieved greater wealth than a similar approach using actively managed equity funds. Interestingly, the study determined that the portfolios containing *actively managed* equity funds accumulated their greatest wealth by taking the opposite

approach of placing fixed income in taxable accounts and actively managed equity funds in tax-deferred accounts. They determined that the paradox was a result of the tax burden on actively managed equity mutual funds combined with the availability of tax-advantaged fixed income vehicles.¹

Harvesting Tax Losses and Heeding Dividend Dates

There are other ways an investment advisor who is familiar with your individual taxable holdings can be of particular value. He or she can watch for times when a particular holding is experiencing a loss, and recommend “harvesting” that loss to offset realized gains. Your advisor also can help you time the purchase and sale of holdings to avoid paying unnecessary taxes generated on funds’ scheduled dividend dates.

¹ *Asset Location for Retirement Savers*. National Bureau of Economic Research, Working Paper 7991, November 2000.

Worth Repeating Worth Repeating

// The long-term goal of investing is to multiply the eggs in our basket. Most people are very focused on producing more eggs (getting high returns) but pay little attention to the fox that perpetually robs the hen house. If you ignore the fox, soon there will be nothing left to produce more eggs. That fox is taxation. //

— Scott West & Mitch Anthony
Storyselling for Financial Advisors

Tuition Bill From 2000 (cont.)

6. Past tax efficiency of actively managed funds is not a good predictor of future tax efficiency.

This lesson was taught particularly well in 2000 by Warburg Pincus' Japan Small Company Fund. Riding the 1999 Internet wave, the fund returned an annual **329** percent. As investors rushed in, assets rose from \$50 million at year-end 1998 to \$1.1 billion by year-end 1999. Then the fund value dropped 54 percent by July 31, 2000; panicked investors redeemed until assets dropped to \$257 million. On August 11, the fund announced a capital gains distribution of 56 percent of the fund's net asset value, the sixth largest on record, despite its prior record of 94 percent tax efficiency.³

7. IPOs are poor investments for the average investor.

The persistent underperformance of IPOs after their initial offering continued into 2000. A recent study examined IPOs brought to market by the four largest investment banking firms. The average IPO closing prices on August 24, 2000 compared with the average closing prices on the first day of trading ranged from a high of +0.9 percent by Goldman Sachs to a low of -14.7 percent by Morgan Stanley.⁴

8. There is almost always a place for fixed-income assets in a portfolio ... but avoid taking on risk there.

After the bull market of the 1990s, some investors have forgotten that equities have provided higher returns than fixed income because they are riskier. An appropriate allocation to investment grade short-term fixed-income assets lets you avoid panic selling during market reversals. If the objective of your fixed income is to act as your safety net, we believe it counterproductive to take on additional risk by "stretching for yield" using high yield (junk) bonds, long-term bonds or long-term bond funds. If you are going to take risk, take it using the equity portion of your portfolio.

9. Sector investments (such as tech stocks) are speculations, not investments.

There is little if any reason to expect any one sector to outperform another over the long run. Even if there were data leading an investor to make such a judgment, it is highly likely that the data already is incorporated into the market's pricings.

We hope that, by taking to heart the preceding lessons taught to investors in year 2000, the reader is now ready to "graduate" to passive asset class investing.

¹ *Wall Street Journal*, March 14, 2000.

² *New York Times*, December 14, 2000.

³ TheStreet.com, August 15, 2000. Based on Morningstar tracking since 1984.

⁴ *Journal of Finance*, March 1995.



Question: In his book *The Fortune Sellers*, William A. Sherden studied the performance of seven forecasting professions:

1. Demography
2. Economics
3. Futurology
4. Meteorology
5. Organizational planning
6. Stock market forecasting
7. Technology assessment

Who among them had the best predictive powers?

Answer: Sherden concluded that none of the experts were very expert. But the forecasters we most often joke about — meteorologists — actually demonstrated the best predictive powers relative to the other groups. Perhaps it does take a weatherman to know which way the wind blows.

Our Basic Tenets

Our objective is to design portfolios using passive asset class funds that maximize investors' returns within their tolerance for risk. Here is what sets us apart:

- ▲ Fee-only investment management
- ▲ A disciplined investment strategy
- ▲ Access to institutional no-load passive asset class funds

- ▲ An academic Nobel Prize-winning investment approach
- ▲ Continued access to academic research
- ▲ A tax-efficient focus, with valuable tax and estate-planning ideas
- ▲ Risk tolerance assessment
- ▲ Periodic portfolio rebalancing
- ▲ Regular communications and state-of-the-art reporting
- ▲ MOST IMPORTANT ...
A TRUSTED ADVISOR RELATIONSHIP

FOCUS

Focus Asset Management Company
A Registered Investment Advisor
5101 Cleveland Street, Suite 104
Virginia Beach, VA 23462
Phone: 757-499-5000
Fax: 757-499-6837
E-mail: info@focusasset.com