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Buying Track Record

Investors rely on track record to select investments. There are many reasons why this should be so, but a primary factor is that, being interested in building wealth, investors focus on investment return. They generalize from recent investment history, just as they do in other areas of life, where this approach is often useful and rewarding.

Investors apply this process to investment decisions because:

- We want to believe that recent returns convey important information.
- We want to believe that this information will allow us to select good investments.
- We want to believe that selecting good investments will result in a well-designed portfolio.

The practical outcome is a focus on recent history. Investors prefer investments that have recently earned high returns. Recent returns are given more weight than long term returns, and investments with recent poor returns are shunned as risky.

Available information reinforces our natural tendency to choose investments based on recent performance. We are barraged with fund performance information from the financial press, fund advertising and promotion, and third party services such as Morningstar, Lipper and CDA. We have little other data to make financial

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World Market Survey

Reversal of Fortune

Much has been written about the rise and fall of Japan as a dominant world industrial power. The chart below illustrates how the Japanese stock market has struggled through the mid 1990's, ending a five-year run with a net negative return.

Investors may also remember the negative appraisal of Western European prospects three years ago. Ballooning deficits, inelastic, over-regulated labor markets, massive unemployment, aging workforces and an apparent lack of technological prowess led to gloomy prognostications. The pundits called it "Eurosclerosis".

Just as the rise of Japan in the eighties was unexpected, Europe's performance in the mid nineties surprised the experts. The fiscal and regulatory discipline forced on European governments by the entry requirements of the approaching European Monetary Union, combined

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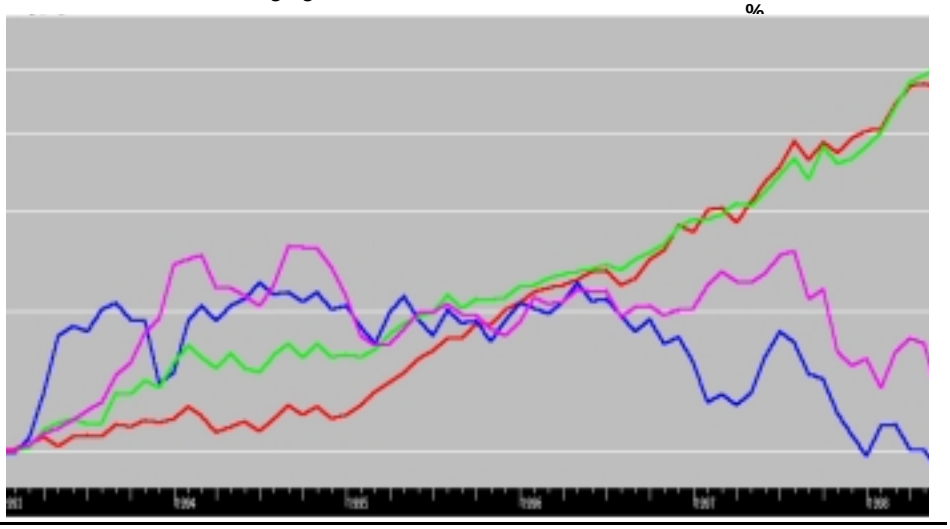
U.S. & World Market Returns
January 1, 1993 - June 30, 1998

S&P 500 Stock Index	21.81%
MSCI Japan Stock Index	-0.67%
MSCI Europe Stock Index	22.47%
MSCI Emerging Markets Index	0.88 %



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with increased cross border competition, has spawned innovation, cost-cutting, and focus on shareholder value among European companies. Last year European markets, in the aggregate, matched the returns on the S&P 500. Thus far in 1998, the top twelve performing stock markets are in Europe, with returns ranging from 20% for Switzerland to 58% for Finland.

The sudden reversal in the performance of the Japanese and European stock markets and their respective economies suggest investors should never underestimate the ability of a stock market, or an economy, to change rapidly. Substantial gains and losses are quickly seized upon by the press, but always after the fact. This is what makes market timing so difficult.

Emerging Markets Plunge Again

Offering a stark contrast to burgeoning stock prices in Europe and the U.S., emerging markets in Asia, Latin America and Europe/Africa were extremely volatile during the second quarter of 1998. Of the 26 countries represented in the Morgan Stanley Emerging Markets Free Index, only four posted positive returns for the quarter. Montgomery Asset Management, sponsor of the largest publicly traded emerging markets mutual fund, traced the global rout to Japan, where a declining Yen and confirmed recession renewed worries that Southeast Asian economies would suffer another round of currency devaluations. Montgomery also reported that slower growth in Asia translated into weaker demand for energy and basic materials (the primary products of many developing countries). As a result, commodity prices declined worldwide, with oil reaching an 11-year low.

Financial turmoil was aggravated by political events, including the resignation of Indonesian president Suharto and nuclear testing in India and Pakistan. Meanwhile, the decline in Latin America was attributed to a general flight to quality as investors deserted the asset class.

What are the prospects for the emerging markets at this juncture? Montgomery claims the short-term environment is creating a catalyst for change in many markets, including an increased emphasis on privatization, faster corporate restructuring, greater transparency in financial reporting, and

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World Market Returns[1]

January 1, 1998 - June 30, 1998

Country	U.S. Dollar	Local Currency	Country	U.S. Dollar	Local Currency
Finland	57.99%	59.15%	South Korea	-0.18%	-18.91%
Greece	53.22	64.56	Japan	-2.59	3.61
Belgium	43.38	43.88	Australia	-2.74	2.29
Spain	40.26	40.63	Norway	-5.92	-2.10
France	38.08	39.13	Philippines	-8.08	-3.23
Germany	34.92	35.65	Thailand	-9.92	-26.11
Portugal	33.88	34.82	Taiwan	-14.56	-10.07
Italy	32.46	33.47	South Africa	-15.31	3.78
Ireland	31.62	30.47	Brazil	-19.15	-16.65
Netherlands	26.14	26.91	Chile	-21.03	-15.93
Sweden	24.85	25.48	New Zealand	-24.58	-14.99
Switzerland	20.18	25.00	Hong Kong	-24.63	-24.64
Australia	16.95	17.46	Mexico	-26.35	-18.18
United States	16.27	16.27	Malaysia	-28.57	-24.02
United Kingdom	14.50	13.49	Singapore	-31.51	-31.32
Canada	9.81	12.73	Venezuela	-50.91	-46.45
Denmark	6.54	7.15	Indonesia	-65.12	20.75

[1] Sources: Dow Jones Global Indexes

(Continued from page 2)

the opening of previously restricted markets. They argue that these changes will eventually result in positive stock market returns.

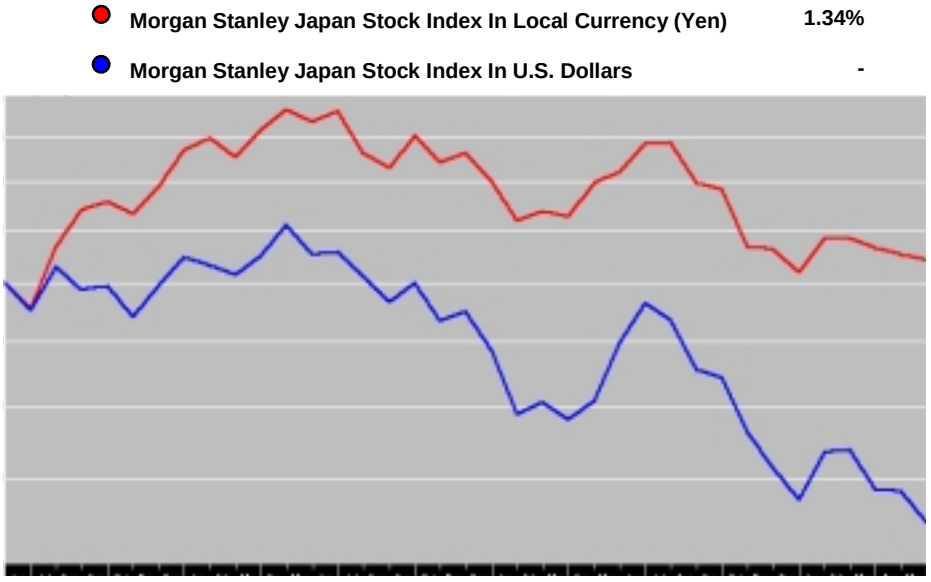
Will these positive developments come to pass, and will they drive up stock prices? As always, we offer no prognostications. The rational behavior of financial markets, however, demands that diversified investors be compensated for assuming market risk. For patient investors, the tremendous volatility in emerging markets should eventually pay off.

The Impact of Currency on Stock Returns

The table on page 2 illustrates the performance of individual stock markets, measured both in local currency and when converted to dollars for U.S. investors. Differences between the two rates of return can be attributed to the increase or decrease in the value of the local currency relative to the dollar. For example, when measured in local currency the Indonesian stock market has posted a 20.75% gain for the year-to-date. However, this year's dramatic devaluation of the Indonesian rupiah against the dollar offset the gain and resulted in a 65.12% loss for U.S. investors. By contrast the South Korean stock market has dropped 18.91% in value in local currency this year, but the recovery of the Korean won effectively offset the loss for U.S. investors.

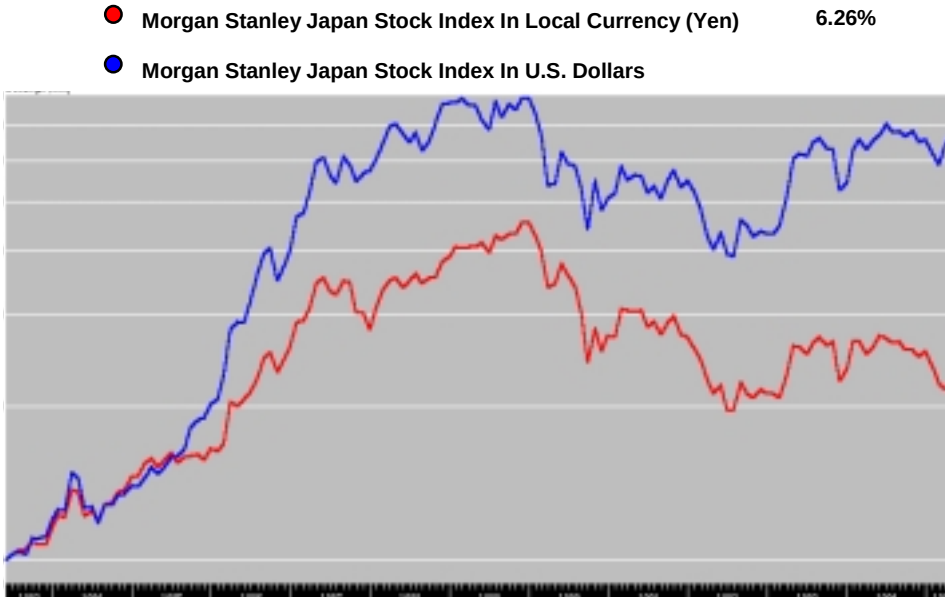
How important are currency fluctuations to international investors? The Asian crisis has demonstrated that currency can play a pivotal role over very brief time periods. The graphs on this page indicate that currency has also been a factor over decades. The first chart illustrates the impact of a strengthening dollar relative to the yen over the past three years. In this case the exchange rates worked against U.S. investors. However, when measured over the previous twelve years (see graph, at right), a period when the dollar was declining in value against the Yen, U.S. investors benefited dramatically.

Cumulative Wealth
3-Year Period June 1, 1995 - May 31, 1998



The impact of currency on stock market returns can actually benefit investors who acquire goods outside their own country. Consider, for example, the situation in the U.S. during the eighties and early nineties, when the dollar was declining in value against the yen. The cost of Japanese goods and services skyrocketed to the point where an average hotel room in Tokyo cost over $1,000 a night. If the hotel room guest also owned shares in the Japanese stock market, the cost of the room would be offset by the currency driven increase in her stock holdings. In other words, when foreign goods become expensive, due to a drop in the value of the dollar, an international stock position can provide additional wealth to purchase costlier foreign goods. Equally important, when the dollar has strengthened and foreign stock returns are diminished as a result, the cost of foreign goods has declined, making them more affordable. Thus, a foreign stock position can help investors maintain equilibrium in their global purchasing power.

Cumulative Wealth
12-Year Period June 1, 1983 - May 31, 1995



Survey of Market Indices & Mutual Fund Averages

Period and Average Annual Compound Rate of Return

	Year-to-date through 6/30/98	5 Years Ending 6/30/98	15 Years Ending 6/30/98
Inflation Index & Risk Free Investments			
Consumer Price Index	0.93%	2.43%	3.34%
U.S. 3 Month Treasury Bills	2.60	5.00	6.32
U.S. Stock Market (Large Companies)			
Standard & Poor's 500 Stock Index	17.70	23.06	17.22
Barra Large Cap Growth Stock Index	23.07	25.36	17.11
Barra Large Cap Value Stock Index	12.13	20.65	17.01
Average Large Cap Mutual Fund ‡	15.11	19.44	14.17
U.S. Stock Market (Small Companies)			
Russell 2000	4.90	16.05	11.10
DFA 9-10 Small Company Stock	5.01	19.05	11.63
Wilshire Small Cap Growth Stock Index	3.97	16.02	10.78
Wilshire Small Cap Value Stock Index	3.08	16.09	18.10
Average Small Co. Stock Fund ‡	6.12	16.10	10.78
Fixed Income (Bond) Markets			
Lehman Government Bond Index	4.19	6.66	9.87
Average Government Bond Fund	3.20	5.31	8.60
Lehman Municipal Bond Index	2.69	6.47	9.38
Average California Municipal Bond Fund ‡	2.16	5.75	8.78
First Boston High Yield Bond Index	4.31	10.43	NA
Average High Yield Bond Fund	4.35	9.91	10.62
Salomon Br. Non-Dollar World Gov't Bonds	2.09	6.36	NA
Average World Bond Fund ‡	1.59	6.06	10.94
International Stocks			
MSCI EAFE Foreign Stock Index	15.93	10.03	15.06
Average Foreign Stock Fund (Morningstar)	13.19	11.49	13.66
MSCI Europe Stock Index	26.49	22.97	18.55
MSCI Pacific Stock Index	-5.93	-6.03	9.84
MSCI Emerging Markets Free Index	-19.87	-1.41	NA
Average Emerging Markets Fund ‡	-15.77	-0.29	4.46

‡ Source: Morningstar *Principia* 06/30/98

Just How Hard Is It to Beat the S&P 500?

The goal of many U.S. mutual fund managers is to beat the market (i. e., the S&P 500 Stock Index). Market beating performance is a sure way to attract dollars to a fund because most investors have the same market beating objective. How successful have mutual fund managers been in outperforming the overall market?

To answer this question, we looked at mutual funds investing in large company U.S. stocks. Morningstar identifies 468 large company funds with a five-year track record. Of these, 34 outperformed the S&P 500 for the five-year period (7% of the total number of funds). The 434 funds that failed to beat the S&P, on average, underperformed the index by 3.6% per year.

Was this five-year period anomalous? Active managers had better luck over the past three years, when 55 of 588 funds beat the S&P 500. The number of winners increased from 7% to 9% of the total. The bad news is that the 533 losers, on average, underperformed the index by a full 5 percentage points per year over the three-year period.

What if we give the managers more time, say fifteen years? Morningstar reports that 174 funds have a fifteen year record. Over this period, there are 13 winners and 161 losers. Once again, winners represent just 7% of the total. And this data does not take into account survivorship bias; it omits the deleted records of all the losers that were closed or merged out of existence.

Index funds now represent 20% of the dollars invested in mutual funds The Vanguard Index 500 fund, with $60 billion in assets, is now the second largest mutual fund in the country. Considering these results, it is surprising that the ratio of index to actively managed funds is not reversed.

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decisions. Furthermore, other than the horse race between managers, there is no popularly understood theoretical model forming a rational framework for selecting among investment alternatives.

In relying on recent track record, the investor founds an important decision on a relatively small data set: investment performance over a limited period of time. The limited data set can bias expectations. Investors tend to believe that the current state of affairs will continue.

How Track Record Hides Risk

A more profound difficulty arises, however, because excellent track records mask the risk inherent in the investment process. Although most investors realize that risk is related (in an approximately linear fashion) to reward, superlative track records can obscure this important fact. Consider, for example, reaction to the 31.15% yearly return on the S&P 500 index over the most recent three calendar years (January 1, 1995 through December 31, 1997). Some analysts are speaking of a New Economic Paradigm in which the U.S. economy has become immune to the business cycle (O Brave New World, that hath such creatures in't!).

Where's the risk? The risk, as this story goes, lies in not being fully invested in the U.S. market. In the last three years the investors who took all the risk were those who put money into investments other than U.S. stocks. The proof can be found in the incontrovertible evidence of recent track records. Non-stock and non-U.S. investments either lost value or underperformed the U.S. stock market over the three year period. Thus the investor may now believe that the future return on the U.S. equity market will average 17%, far higher than the historical mean of 10.7%. Perhaps it will. Still, the language of the New Paradigm investors is remarkably similar to descriptions of the go-go markets of the 1960's (remember the "Nifty-Fifty" and the new economic paradigm of the diversified conglomerate?), or the presumed eternal upward march of California real estate values in the 1970s.

The conceptual trap here lies in the tendency to assign all risk to the course of action which, in retrospect, is seen to have failed, and to excuse the course of action which has succeeded. Good track record masks risk. Looking at the record of the S&P 500 over the last few years, it is difficult to spot the risk inherent in that market. Whether or not we spot it, however, the risk is there, embedded in the investment process itself. It is unavoidable. Having advanced this argument, let's go risk hunting in the very spot where risk hides — a good track record.

Hunting for Embedded Risk

Here's an easy hunt — a hunt for squirrels rather than for tigers. Manager A and Manager B both produce a yearly return of 20%. Do you care which one you hire to manage your money? Perhaps not, but you need more information before you can tell. Begin by decomposing the track records to see how the returns were generated. In this case, assume that each manager invested equal amounts in ten stocks with the following results:

Stocks	Manager A	Manager B
A	+5%	+25%
B	0%	-14%
C	-3%	+37%
D	4%	+22%
E	-6%	+16%
F	+2%	-3%
G	-1%	+42%
H	+3%	+31%
I	-2%	+15%
J	+198%	+29%

Intuitively, most investors would agree that they would not want Manager A to manage their nest egg. Manager A's track record reveals no ability to pick winning stocks. In fact, A saved his bacon by making what seems to be a single lucky bet. Good track record can mask investment risk.

Using Statistical Tools to Evaluate Track Record

Significance testing is a method researchers commonly use to gauge investment risk. Simply put, the statistician measures the amount of variance in the period-to-period returns. Given this variance "benchmark," he inquires into the likelihood that the final track record is either a product of random chance or is attributable to investment skill. Analysis of the track records shows that Manager A's variance is 12.93 times higher than that of Manager B. Given this amount of variance, it is difficult for Manager A to make the claim that he is skilled rather than lucky. Mathematical analysis helps to confirm our intuitive judgement regarding which manager to hire.

Quantitative analysis can provide investors with a glimpse into the future. The analysis illuminates the probable consequences of investment decisions. Investing money based solely on speculative opinion is highly uncomfortable. The statistician's tools bring out the informational content of track record in a clear and useful form. Not only do the tools answer the skill-versus-luck question, but, more importantly, they demonstrate the likely future risk and return tradeoffs.

The variance analysis cited above is an example of an Analytical Model. We could also employ a Simulation Model. Simulation models use repeated sampling instead of computational analysis. We can use a simulation model to examine a real investment with a great "proven" track record. The simulation model shows the real (though not historically realized) risk obscured by the fabulous track record. This investment earned a 27.73% compound annual return over a ten-year period, with one annual return in excess of 91%! Year-by-year results are detailed in the graph on the next page.

Illumination Through Simulation

A long-term track record of over 25% per year is excellent by any standard. Even better, in this case it was

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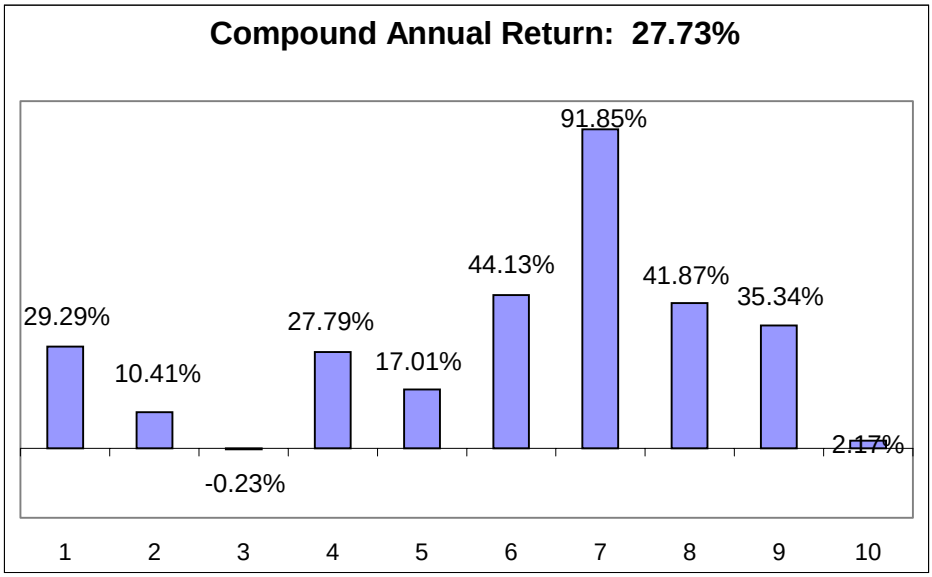
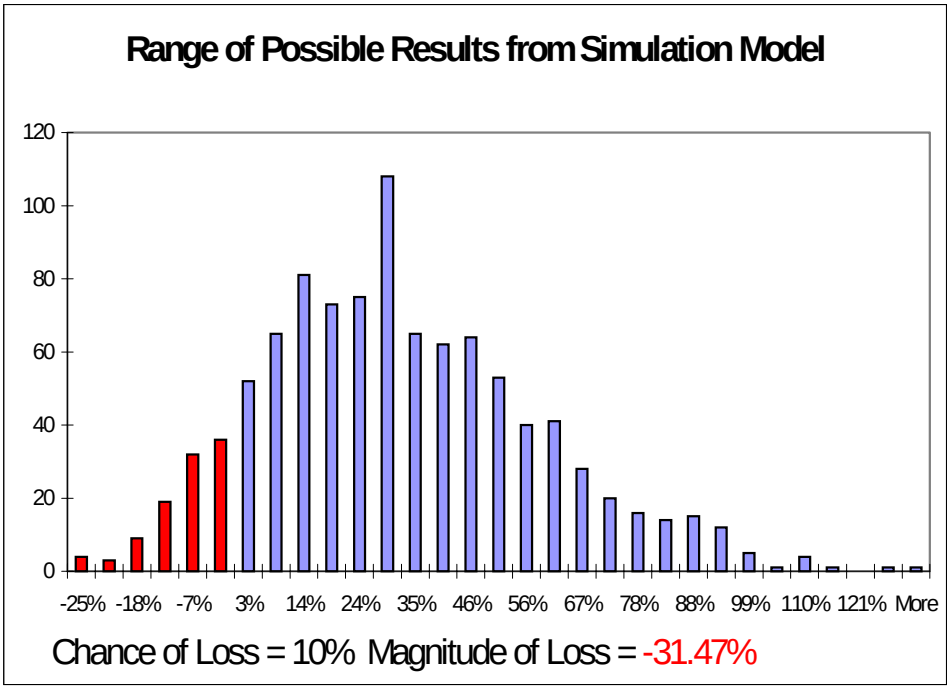
achieved with little apparent risk. In its only negative year (year 3), the investment was down just 0.23%. To illustrate embedded risk, we decompose the track record month-by-month over the ten-year period. We're not interested in what happened (we already know this), but what might have happened. We randomly assemble ten-year return patterns by shuffling the pool of 120 actually experienced monthly returns. This simulation approach enables us to determine the range of possible returns with considerable confidence. The chart, below, summarizes the results of a simulation composed of 10,000 iterations of this shuffling of month to month returns over the ten year period. Even though the sampling comes from a particularly happy time in this investment's life, the downside risk revealed by the distribution is considerable. Simulated results indicate a worst case annual return of –31.47%.



Collapse of the Last "New Paradigm"

This investment is an index of Japanese large company stocks, adjusted for U.S. currency, over the period 1980 through 1989. At the time, many observers hailed (or bewailed) a new era in world economics. The Japanese economy was destined to supercede the U.S. as the primary engine of global wealth creation. The "Japanese Model" of industrial organization was studied and imitated throughout Asia, and many argued that the U.S. should adopt a Japanese-style industrial policy. However, even during a period of wonderful returns, risk is present, not just as an abstract concept, but as a real possibility that may become manifest at any moment. The index of Japanese large company stocks declined 39% in 1990, and has endured difficult times ever since.

This does not mean that an inevitable doom necessarily lurks just around the corner for U.S. markets. It does mean there is no escaping risk. Risk is embedded in the investment process whether or not it is apparent in any given period. Even after you flip a coin heads ten times in a row, your chance of heads on the next toss is 50/50.



Reducing Variance Enhances Returns

A manager's historical success is meaningful to a prospective investor only to the extent that it can reasonably be expected to continue. However, even those investors who know that chasing managers with superior track records leads to disappointment still join in the chase. It's human nature — people like to pick winners. But portfolios of good investments are usually lousy portfolios.

If we define good investments as those with excellent recent track records, it stands to reason that good investments will have flourished under recent economic conditions. When economic conditions change (inflation, international trade balances, exchange rates, unemployment, growth in GDP, and so forth) recent winners may come to grief. Indeed, if we build a portfolio of investments that flourish under the same narrow set of economic conditions, we have unwittingly created substantial risk by concentrating our bets on a small set of economic factors. Such portfolios of (recently) good investments increase the

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expected variance of investment returns. Consider the following simple example:

Year	Investment P	Investment Q
1	-20%	1%
2	+25%	1%
3	-20%	1%
4	+25%	1%

Investment P averaged 2.5% per year while Q averaged 1%. Nevertheless, for every dollar invested in P, at the end of four years you ended up where you started - with $1.00. Meanwhile you earned $1.05 for every dollar invested in Q. Why? P experienced considerable variance, while Q had none. Loading up on high variance investments with good recent track records may be hazardous to your wealth! The real issue, therefore, is not which investment made the highest return, but rather which investment earned the most return per unit of risk undertaken. Academics call this measure "risk-adjusted return."

Virtually every independent study concludes that, over the long run, well-diversified portfolios have a better chance of earning a higher level of real wealth. Diversification increases risk-adjusted return, enhancing long-term wealth. This is why people diversify.

Say that you put all your eggs in one basket (one stock, one mutual fund, etc.). During the subsequent year, a well-diversified portfolio earns 10% and your one egg basket earns 20%. Did you get a free 10%? No – you concentrated your bet ("put it all on red"). You should have earned more because you took more risk. If you don't believe this, go to Reno and look at the huge payoffs that the lucky winners receive when they concentrate their bets! Decide for yourself if this is a prudent way to accumulate wealth.

Compound Wealth =
Average Return – ½(Variance)

Variance from average returns – i. e., portfolio volatility – subtracts from ending wealth. The dollars I earn from my investment program will decrease if variance increases. Nobody escapes the mathematics of compounding.

Choosing Investments Based on Track Record

Here's another real-world example. Let's assume that you want a portfolio to provide wealth-accumulation over forty years. Which investment would you choose to buy today, given only the recent track records:

Sample Return Series: 1991-1996

Year	Series A	Series B
1991	51.61%	7.11%
1992	26.03%	**-26.10%**
1993	19.86%	14.16%
1994	**-2.30%**	29.49%
1995	32.62%	**-3.57%**
1996	18.86%	**-22.79%**
Annualized Compound Return	23.38%	**-2.27%**
Risk	17.75%	21.60%
Growth of $10,000	$30,530	$8,700

If we increased your data set to include the long term track record from 1973 (see table at right), which investment would you select?

The Diversification Benefit

Track record analysis becomes meaningful only when we consider the two return series together. When these particular series are combined (see the table on the following page), we see that returns from the two series tend to offset each other.

A combination of equal parts Series A (Ibbotson's index of U.S. small company stocks) and Series B (Nomura's index of Japanese small company stocks) produces much less return variance than either investment alone. And with lower variance, we experience a significant increase in ending wealth. Diversification works. In the words of Nobel Prize winner Merton Miller: "Diversification is your buddy."

Reducing Risk by Timing the Market

We just demonstrated that ending wealth is a function of risk adjusted return. If only we could know when stocks were about to crash. We could quickly move out of the market and into safer investments, such as bonds or cash. Wouldn't this be a safer way to invest?

Sample Return Series: 1973-1996

Year	Series A	Series B
1973	**-38.96%**	0.38%
1974	**-28.65%**	**-2.23%**
1975	65.71%	15.92%
1976	51.05%	38.11%
1977	26.80%	34.00%
1978	25.80%	95.71%
1979	43.19%	**-20.63%**
1980	41.86%	35.17%
1981	**-2.69%**	**-8.52%**
1982	24.26%	**-5.05%**
1983	33.78%	41.75%
1984	**-11.58%**	13.22%
1985	26.16%	62.83%
1986	3.45%	60.35%
1987	**-14.16%**	87.58%
1988	19.92%	32.45%
1989	8.22%	38.51%
1990	**-28.03%**	**-33.36%**
1991	51.61%	7.11%
1992	26.03%	**-26.10%**
1993	19.86%	14.16%
1994	**-2.30%**	29.49%
1995	32.62%	**-3.57%**
1996	18.86%	**-22.79%**
Annualized Compound Return	12.96%	15.56%
Risk	27.20	34.37
Growth of $10,000	$186,400	$321,400

Unfortunately, market timing's risk reduction benefits are predicated on an ability to make successful market timing calls. The risk of being 1/3 in stocks, 1/3 in bonds, and 1/3 in cash over a period of time is very different from the risk of being 100% in stocks for 1/3 of the time, 100% in bonds for 1/3 of the time, and 100% in cash for 1/3 of the time. The former strategy controls risk; the latter strategy sends it through the roof. When we measure value added in terms of risk-adjusted performance, it becomes very difficult for the market timer to justify

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Benefits of Diversification: 1973-1996

Year	Series A	Series B	50% Series A / 50% Series B
1973	**-38.96%**	0.38%	**-19.29%**
1974	**-28.65%**	**-2.23%**	**-15.44%**
1975	65.71%	15.92%	40.81%
1976	51.05%	38.11%	44.58%
1977	26.80%	34.00%	30.40%
1978	25.80%	95.71%	60.75%
1979	43.19%	**-20.63%**	11.28%
1980	41.86%	35.17%	38.51%
1981	**-2.69%**	**-8.52%**	**-5.60%**
1982	24.26%	**-5.05%**	9.60%
1983	33.78%	41.75%	37.77%
1984	**-11.58%**	13.22%	0.82%
1985	26.16%	62.83%	44.49%
1986	3.45%	60.35%	31.90%
1987	**-14.16%**	87.58%	36.71%
1988	19.92%	32.45%	26.19%
1989	8.22%	38.51%	23.37%
1990	**-28.03%**	**-33.36%**	**-30.70%**
1991	51.61%	7.11%	29.36%
1992	26.03%	**-26.10%**	**-0.04%**
1993	19.86%	14.16%	17.01%
1994	**-2.30%**	29.49%	13.59%
1995	32.62%	**-3.57%**	14.53%
1996	18.86%	**-22.79%**	**-1.96**
Total Negative Years	**7**	**8**	**6**
Annualized Compound Return	12.96%	15.56%	**15.97%**
Risk	27.20	34.37	**22.93**
Growth of $10,000 (Ending Wealth)	$186,400	$321,400	**$349,900**

History teaches that both investment managers and clients need help if they are to hold successfully to the discipline of long-term commitments. This means restraining themselves from reacting inappropriately to disconcerting short-term data and keeping themselves from taking those unwise actions that seem so "obvious" and urgent to optimists at market highs and to pessimists at market lows. The best shield against the outrageous attacks of acute short-term data and distress are knowledge and understanding committed to writing.

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his activities. One wrong call can wipe out a lot of accumulated dollars. But what if we could find the successful market timers? We ought to be able to locate them by reviewing their track records…...

Avoiding the Sucker's Bet

Track record is useful only when combined with statistical analysis (using simulation or analytical models) that illuminate the embedded risks underlying the pattern of returns. Such analysis mines the history of an investment to reveal the buried information it carries about possible future results. A naïve reliance on recent track record leads to obvious but erroneous conclusions. Using track records, the investor may chase the latest set of hot hands, or flee the latest crashing asset class, to the long-term detriment of the portfolio. To avoid this kind of sucker's bet, investors should rely on the stabilizing influence of long-term investment policy. As Charles Ellis so eloquently summarized the issue in his definitive volume, Investment Policy:

Investment Quarterly

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