

SUMMER 2000

THE INDEPENDENT ADVISOR

Quarterly Client Newsletter

The Information Age Isn't All It's Cracked Up to Be --A Little Knowledge Can Be a Dangerous Thing

Is most information investors get from the media and Wall Street analysts really all that useful to them in making a decision to buy or sell a particular company's stock? According to Gretchen Morgenson of the New York Times, there is a big difference between information and knowledge. Edward Kerschner, chief investment strategist at Paine Webber, believes that "the instant dissemination of information today carries a substantial cost: the tendency among investors is to act first and think second."

As an example of this, he cites the correlation between the growth in viewers of CNBC, the investing channel, and volatility among the Nasdaq stocks (which as most of you know, is weighted heavily toward technology). It appears that viewers/investors are reacting very spontaneously, without much forethought, to a "hot stock tip," for instance, and purchasing the stock of a particular company that's been discussed on TV for all of 30 seconds.

The research reports written by Wall Street analysts working for large brokerage firms like Merrill Lynch, while containing a lot of data, may not be particularly useful either. Researchers whose firms have or want to have investment banking relationships with the companies they follow have been proven to be more positive in their assessments than those whose firms do not have such an association.

Moreover, three university professors who conducted a study examining analysts' forecasts from 1982 to 1997 found that analysts generally react to changes in stock prices rather than cause them.

What is an investor to do? The professors concluded that "investors would be well advised to shut out all the yammering about earnings expectations...and focus instead on the financial information reported by the companies themselves" in their annual reports and 10-ks.

More Information, More Volatility

This is advice, of course, that most mutual fund managers follow assiduously--which is one reason I recommend to my clients that they invest in mutual funds, as opposed to individual stocks. There is no free lunch--no easy, quick way to evaluate a stock. You must do your homework (as opposed to merely listening to TV commentators or Wall Street analysts) or let the fund manager do it for you.

How to Take the Guesswork Out of Investing

For all the projections and assumptions we make about future stock returns, there is no way to really know what they will be. Future stock market returns are *completely unpredictable* in the short-run. But we can have some control over four primary determinants of investing that do affect returns in the long run: time, cost, tax-efficiency and risk.

Time: we have the power to choose whether we will be long-term investors or short-term speculators. Even with riskier investments, studies have shown that over time, volatility becomes less of a factor since stocks tend to go up more often than they go down. That you might be 15% down on your investments in year 1 shouldn't matter if, as a long term investor, you're expected to achieve, say, 10% positive returns on average over a 10 to 20 year period.

Cost: holding onto your stocks keeps your brokerage costs down, so think twice before you trade frequently. Also, several recent studies have found that low-cost mutual funds tend to outperform high-cost funds. So seek out funds with below-average costs - - as well as a good track record - - and chances are you'll be pleased with future performance.

Tax-efficiency: if you are investing in a taxable account, look for funds that are tax-efficient, in the sense of minimizing capital gains distributions every year. Index funds, for example, tend to be fairly tax-efficient in most market conditions. Morningstar, the service that evaluates mutual funds, looks at how aware each mutual fund manager is of the impact of taxes on shareholder returns.

Risk: too few investors look at the risk vs. return profile of mutual funds. Be sure you're investing in a fund that gives you sufficient average gains for the risks you're taking. Likewise, if you're considering a high-flying fund with a top performance record, make certain you understand what risks that fund will be taking with your money. It's nice to consider getting a 90% return, as lots of funds did in 1999, but would you be willing to do so if you knew the fund was chock full of volatile small technology firms, many of which historically go out of business in their first five years?

Following these criteria is truly a way to exert a measure of control over what kind of return you achieve with your portfolio.

FYI

A Fable for these Heady Times

"...over a three year period, the McCoy brothers bet almost their entire investment portfolios, as well as hundreds of thousands of dollars borrowed from their brokerage account on margin, on just one stock: the Wave Systems Corp., a tiny semi-conductor company.

Terrance Odean, a professor who researches investor behavior, calls a strategy like the McCoy's "the correct formula to maximize the chance of a huge windfall. It's also the correct formula to maximize the chance of losing everything," he added.

This is exactly what happened with the McCoy brothers. One held over \$2 million worth of the stock; the other \$508,000, on investments of \$120,000. By April 17, when the stock plummeted, they were down to virtually nothing.

You could say the story of the McCoy brothers and others like them makes a case for diversification. You could say it makes a case against margin investing."

Danny Hakim
The New York Times
June 18, 2000

ABOUT THE ADVISOR...

Christopher Kuehne is an independent, fee-only, Certified Financial Planner (CFP) and Registered Investment Advisor. He has worked in the financial services industry for 18 years in various capacities, including 12 1/2 years on Wall Street as a Vice President at Merrill Lynch and Bankers Trust Company. Mr. Kuehne is a member of the Financial Planning Association and the National Association of Personal Financial Advisors (NAPFA).