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It ain't necessarily so....

a presentation to
QWAFAFEW, Boston
by Langdon Wheeler, CFA
October 12, 2004

It ain't necessarily so.
It ain't necessarily so.
The things that you're liable,
to read in the Bible
They ain't necessarily so.

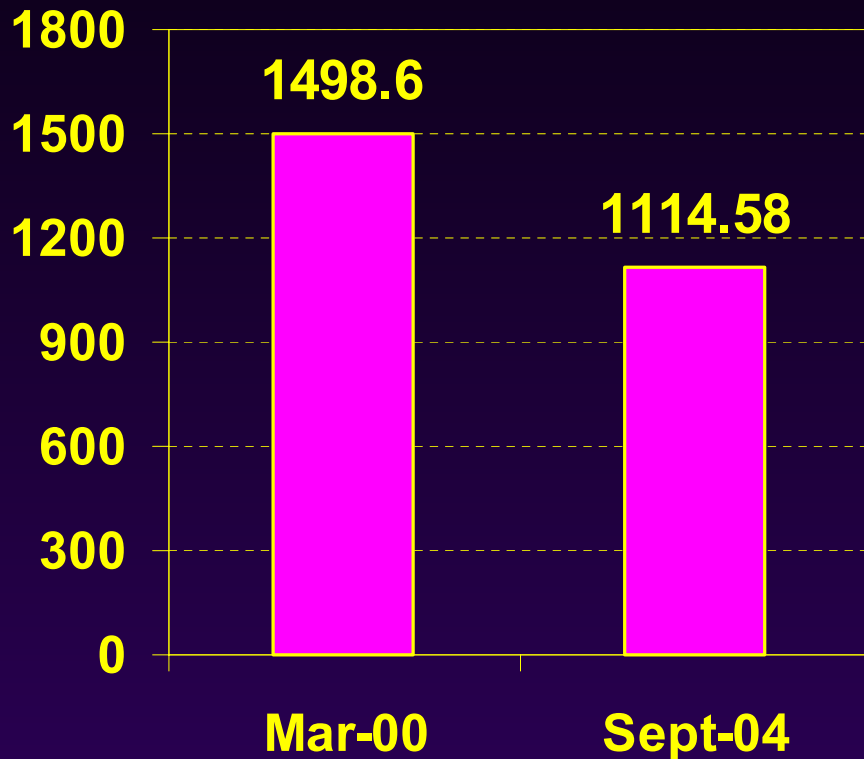
Dubose Heyward & Ira Gershwin
"Porgy and Bess" (1934)

Overview

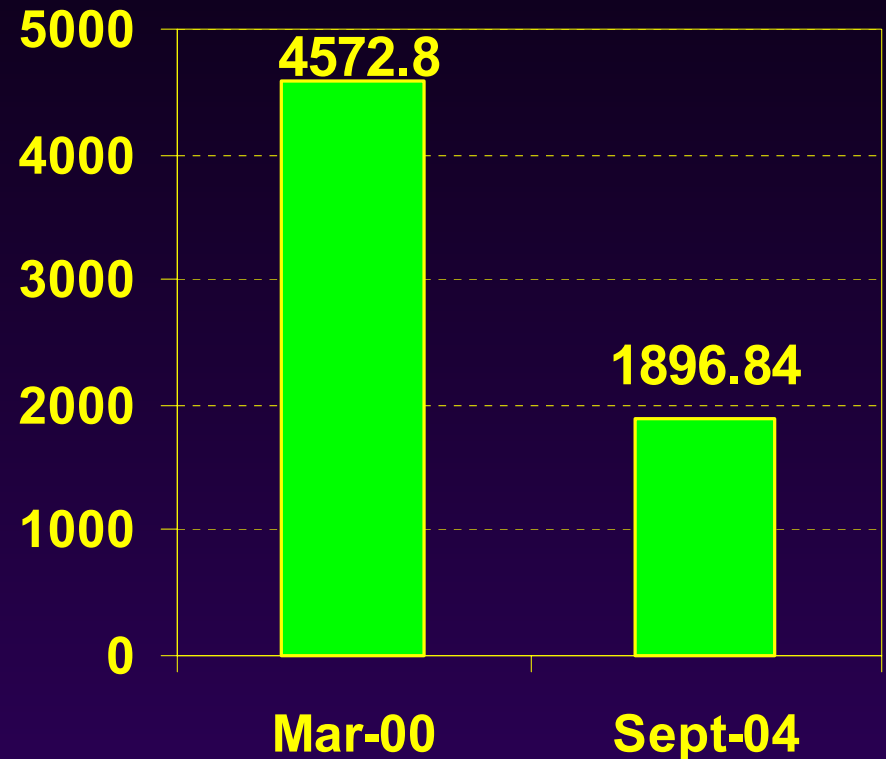
- The returns of the average stock and the stock market averages have disconnected
- Great wealth has been destroyed by index-centric investors following conventional wisdom
- Have we merely distorted the market or is our paradigm flawed?
- Understanding paradigms and paradigm shifts illuminates the fragility of our current beliefs
- Some elements of the next paradigm are visible today

U.S. indices have not recovered since the Bubble(s)

S&P 500 down 26%

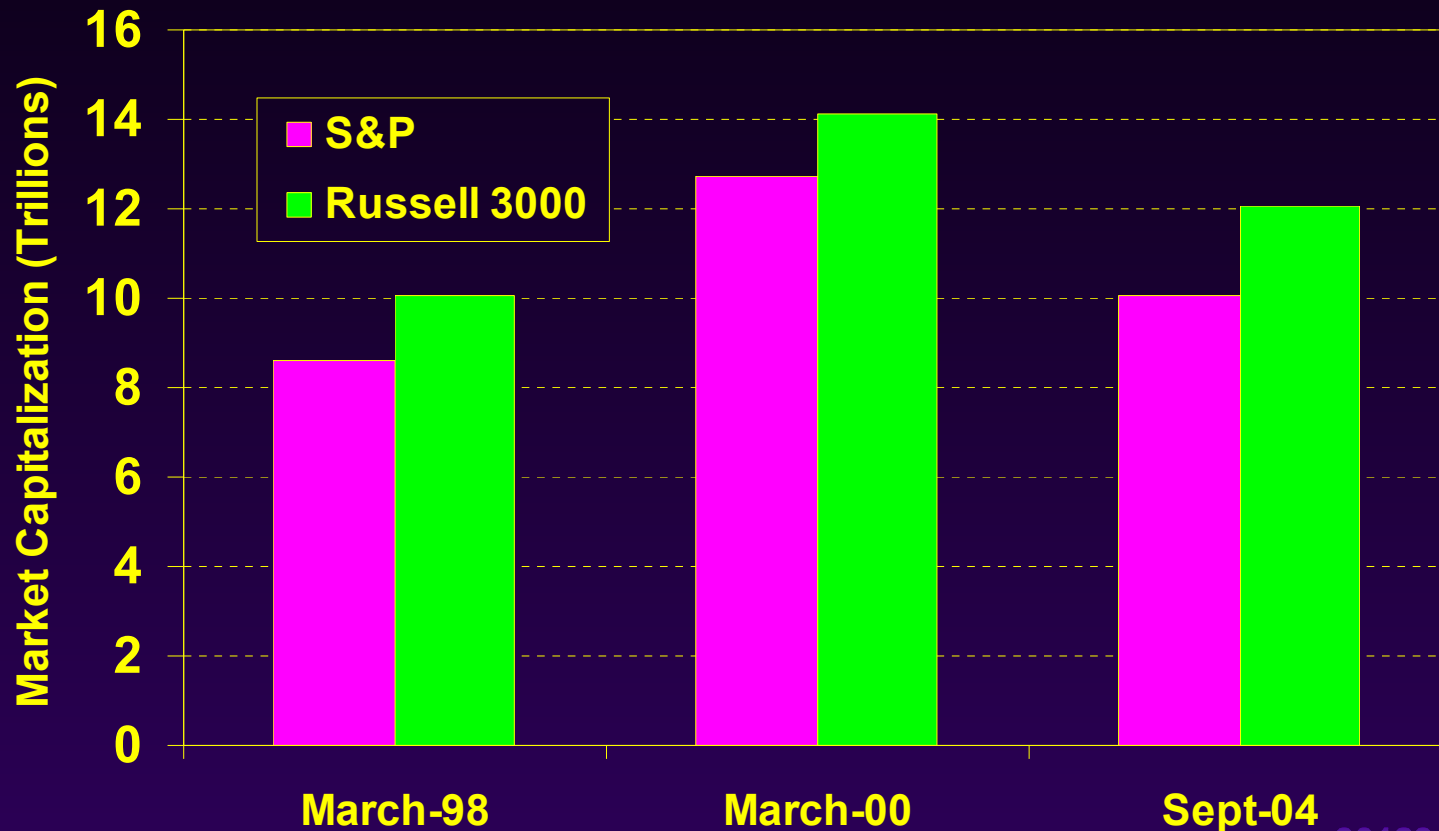


NASDAQ down 59%



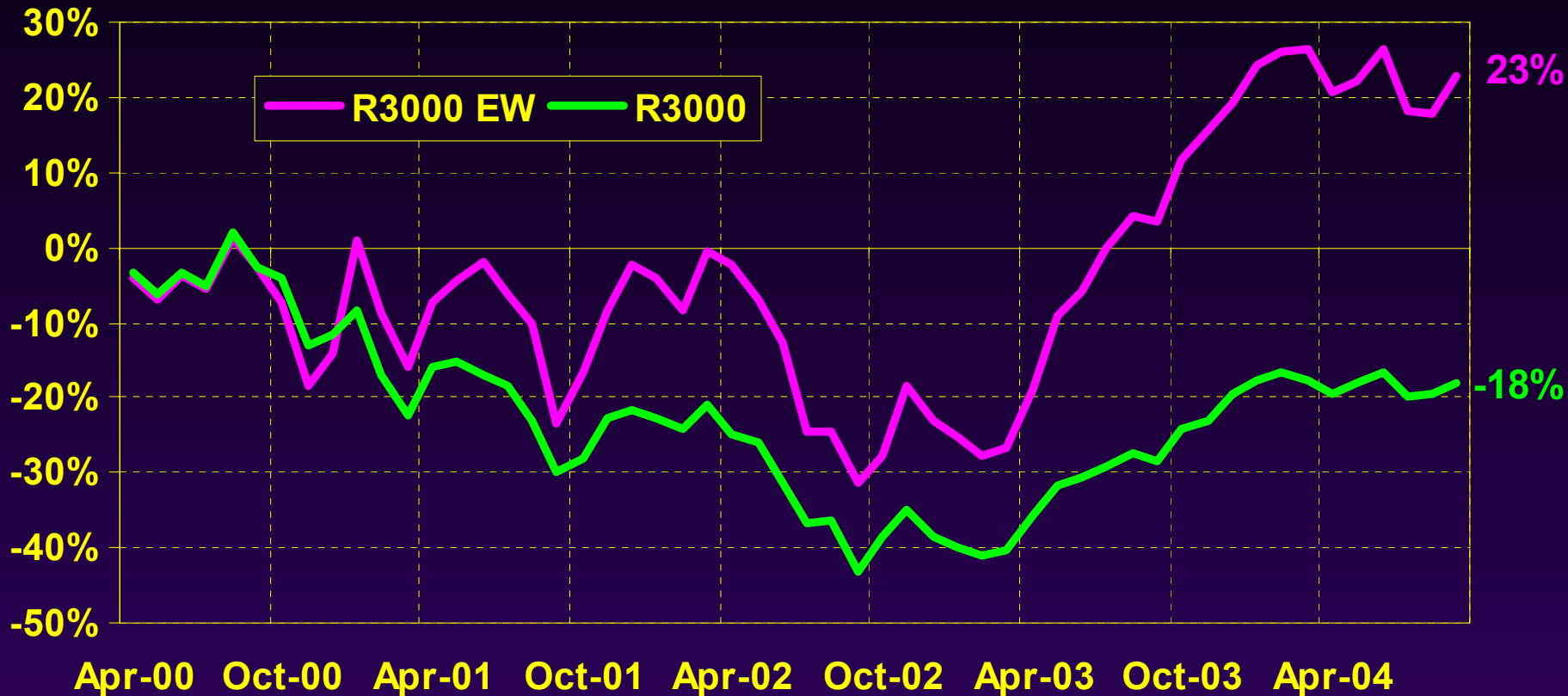
\$2 trillion in capitalization has been lost

Market Capitalizations of the
S&P 500 and Russell 3000 Indices



While the average stock returned +23%

Russell 3000 Equal-Weighted vs Russell 3000 Index
Cumulative Return April 2000 through September 2004



Market breadth has been improving since the Bubbles' peak

NYSE Cumulative Advance-Dcline Line vs S&P 500 Index

Data through October 1, 2004



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Stocks & the indices have disconnected

- Indices down - 30%
- Average stock + 25%
- Blindfolded chimps throwing darts at the financial pages beat indexers by 55% in 4 years
 - Now THAT'S active management!
- \$ 2 T in lost capitalization vs. \$ 3 T gain
 - where is the missing \$ 5 T?
 - what is \$ 5 T?
 - 2002 GDP of China

A frightening thought:

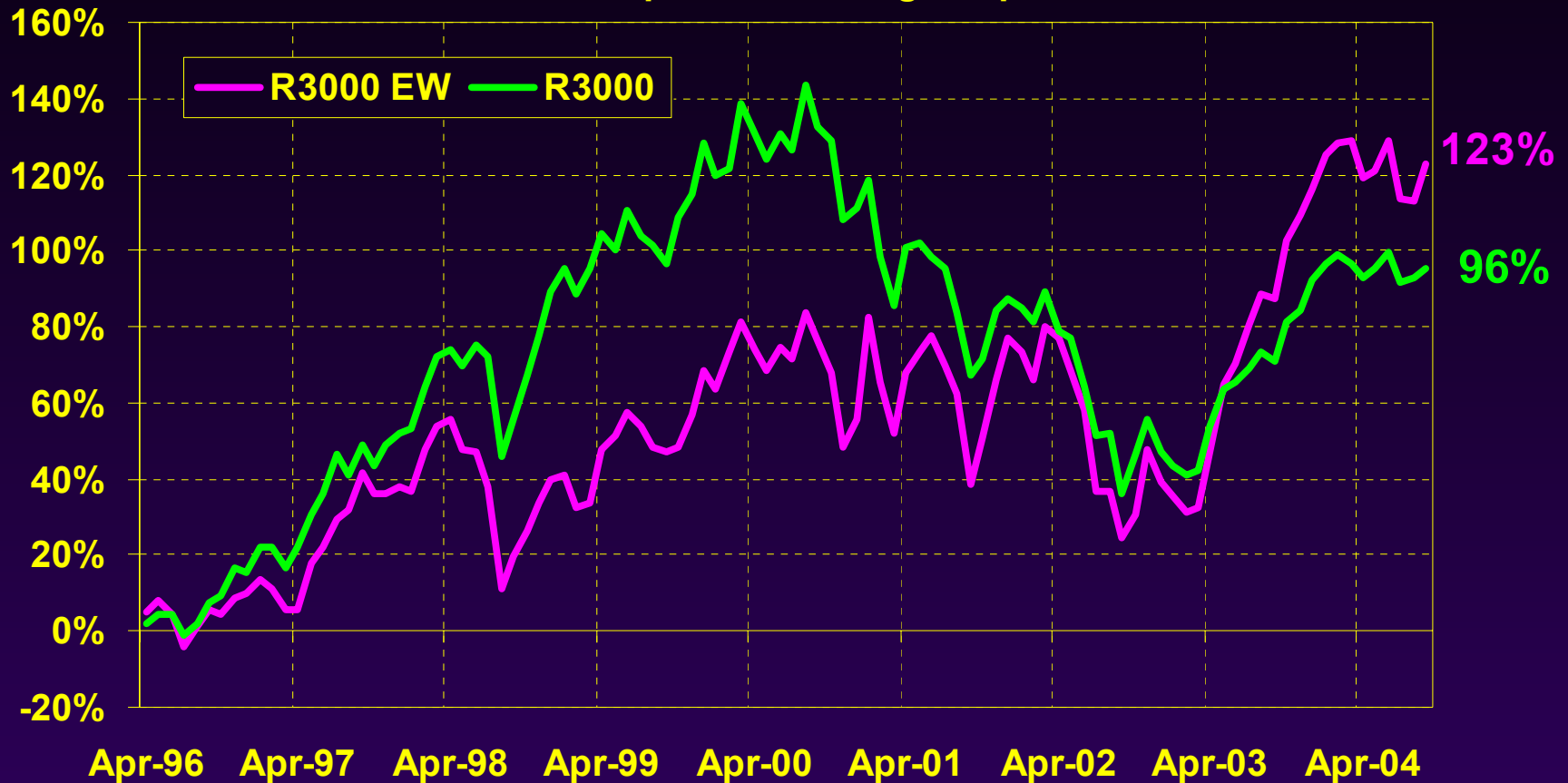
- If Martha Stewart serves 5 months for saving \$46K on inside information
- How long should the investment community serve for losing \$ 5 trillion?
- Answer: 45 million years
 - or 9000 years for each of 5000 culpable investment professionals
 - that's almost "life"

How could this happen?

- Late '90s investors wanted market exposure
- Indexing was outperforming active
- Money flowed into indexing
 - the more expensive the largest stocks became, the more they must be bought
- 70% valuation premium for the Megacap 50 at the peak
- 54% of R3000 capitalization in Megacap 50
- Active managers felt compelled to control cap exposures

Cap-weighted trounced equal from Q2 96 thru Q1 2000

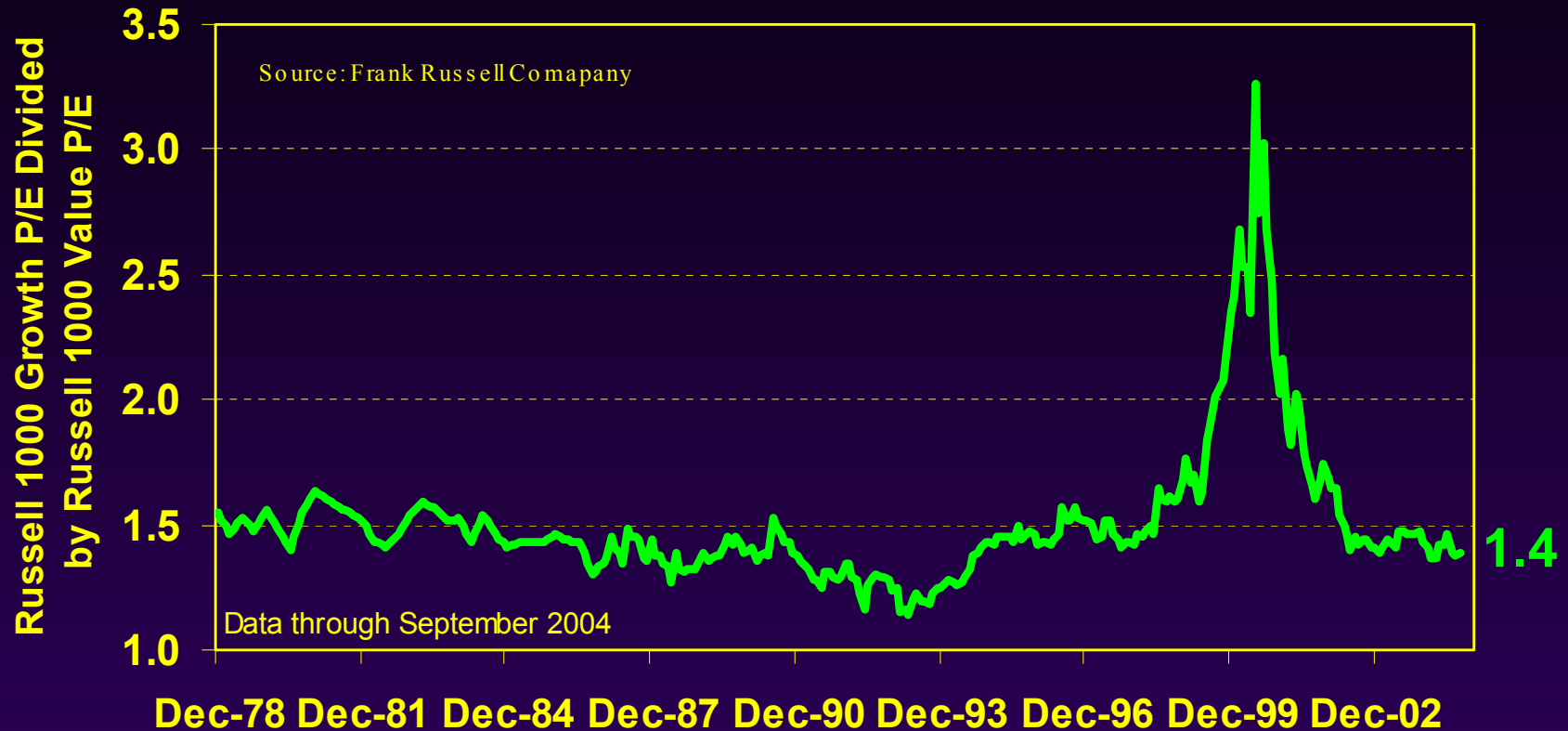
Russell 3000 Equal-Weighted vs Russell 3000 Index
Cumulative Return April 1996 through September 2004



The Growth Bubble is well understood

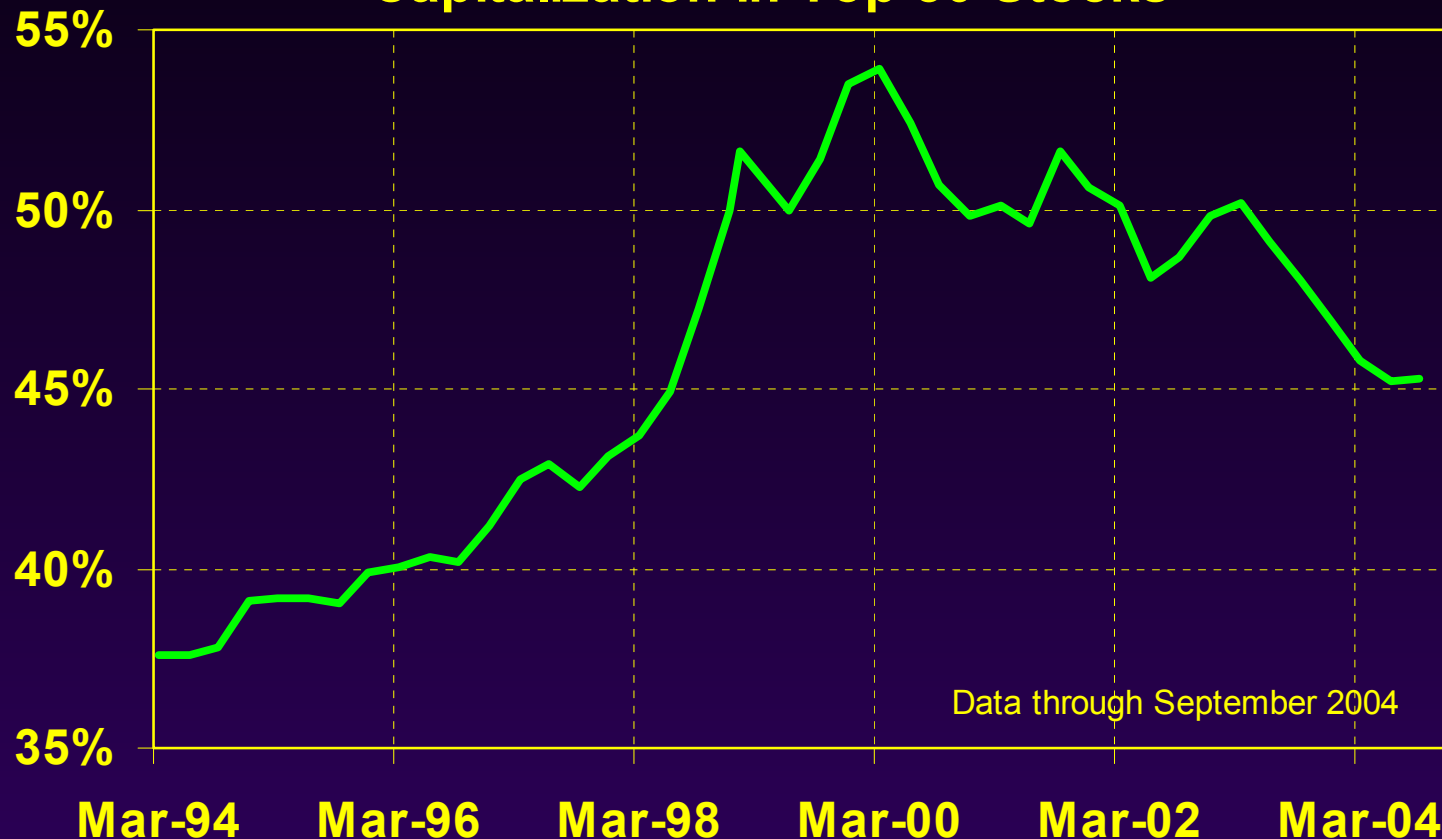
Ratio of Forecast P/E Ratios

Russell 1000 Growth Divided by Russell 1000 Value Index



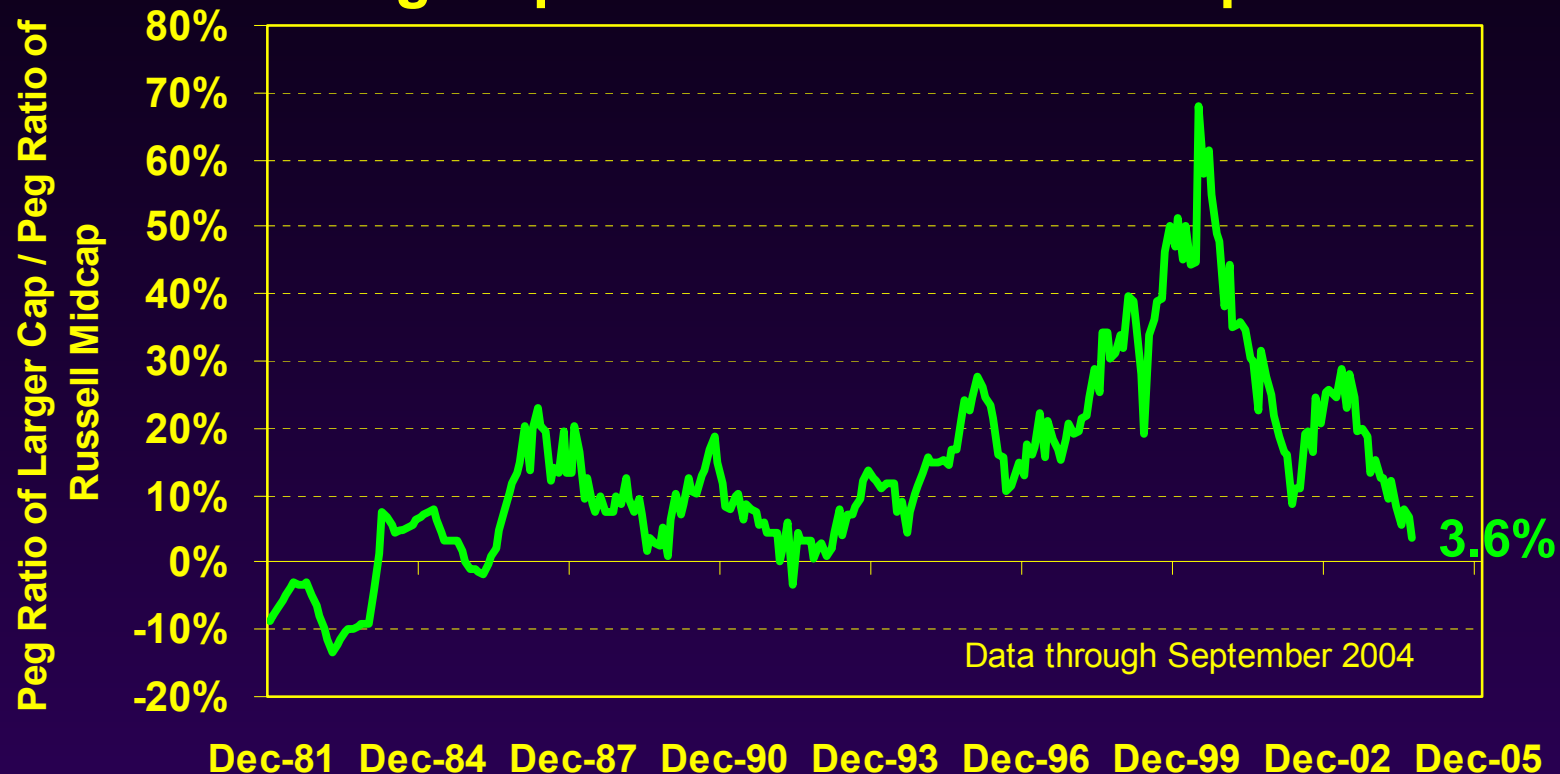
54% of the market in just 50 stocks

Percentage of Russell 1000 Index
Capitalization in Top 50 Stocks



A Megacap Bubble also occurred

PEG Ratio Premium of Megacap 50 over Russell Midcap



What other mischief have we been up to?

- Portfolio insurance - 1987
 - buy high, sell low
- Long-Term Capital Management
 - convergence trades too large to converge
- Common sense and limited liquidity collide with intellectual hubris
 - and the market shudders!
- Are we SURE we know what we're doing?

That most important book.....

- The Structure of Scientific Revolutions

- by Thomas Kuhn

- professor of the History of Science

- first edition published in 1962

- Perhaps the most important book about science written in the 20th century

- 160 pages of accessible prose

- no formulae, charts, or tables

Key points

- Scientific progress is not what you learned in school
 - not a cumulative, smooth accumulation of knowledge
- Prolonged periods of "normal science" punctuated by brief but crucial scientific revolutions
- Scientists don't learn this history in school
 - too busy digesting all they need to know

Paradigm

- A model or belief set to describe nature / reality
- A limited set of variables to measure reality
- A specific set of mathematical tools
- "Normal Science" employs these tools and variables to see if nature conforms to the model

The college of normal science

- At most a hundred people worldwide working at the state of the art
- Writing arcane papers exclusively for each other's consumption
- The public can't understand and is not invited
- Senior people invested in the status quo
 - with narrow expertise

Paradigm Shift

- Too many anomalies that the current paradigm cannot explain
 - but anomalies do not kill the old paradigm
 - it takes a new paradigm to doom the old
- New phenomena, new math techniques launch the new paradigm
- Often from people outside the college
 - Ben Franklin, Robert Dalton, Albert Einstein, Harry Markowitz, Bill Sharpe

Is "paradigm shift" overused?

- Applied to the arts and social sciences
- Kuhn said the social sciences were too young to have paradigms
 - pre-paradigm state with publicly accessible discourse
- Finance developed its first paradigm thirty years ago
- Physical sciences have had several paradigms
- Shouldn't finance expect more paradigms?

A little humility please....

- We are not the keepers of the absolute truth
 - merely the custodians of current intellectual orthodoxy
- Where common sense collides with orthodoxy
 - orthodoxy may be repudiated by a later paradigm

Conventional financial thinking

- The market is a cap-weighted opportunity
- Individual stock behavior is described by capitalization, growth / value, beta, sector
- The market is too efficient to beat
- Indexing delivers the market at minimal cost
- Control risk by not being different than the market (index)
 - Put most of your capital to work in the largest stocks
 - Almost all portfolios look mostly the same

Common-sense problems with indexing

- The average manager cannot beat the market
 - tautological, but doesn't prove that some cannot
 - skilled managers are likely to attract too many assets
 - performance fees align manager and client interests
- Does today's capitalization reflect tomorrow's success? or yesterday's
- Why allocate so much to so few?
- Indexing works best if only you do it
- If no one performs price discovery, prices will not be efficient

Unconventional thinking

- The market is comprised of individual stocks with very different outcomes
- Stock returns are primarily driven by earnings innovations
 - difference between current consensus and subsequent earnings outcomes
 - earnings outcomes are slightly predictable
 - fundamental & behavioral research
 - by definition, this is not an easily observable factor
- Alpha can be harvested with discipline

Toward a new investing paradigm

- Large stocks underperform over long periods
 - more alpha possible in less efficient, small stocks
- Cap-weighted portfolios are inefficient
 - systematically overweight the overvalued stocks
 - and underweight the undervalued
- Stock returns are a little bit predictable
 - old fashioned, fundamental research
 - where will the earnings outcomes be different?

Toward a new investment management paradigm

- Alpha can be reliably harvested
 - constrain assets under management
 - performance fees
 - long / short to achieve maximum alpha
 - use futures overlay to restore equity market exposure
 - a commitment to continuous research and process improvement
- Beta should be free
 - but alpha is very valuable

"They ain't necessarily so....."

Russell 1000 Equal-Weighted vs Russell 1000 Index

Cumulative Return January 1979 through September 2004

