

MONEY MANAGER NEWSLETTER

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Donald R. Stanforth, President

***THE CASE AGAINST INDEXING...**Last quarter we addressed the advantages of indexing. Now we will look at the active approach to investment management. Every active investment manager I asked, during the past calendar quarter, was very willing to give me input regarding their view of active management. Here are a few...*

DAVID COMO – TRAINER WORTHAM

1. Investors should recognize that mutual funds focus most of their attention on very expensive stocks (high P/E P/B ratios). The top 50 stocks in the S&P have P/E multiples double that of the market.
2. Because of the focus on the top 50 stocks, the S&P 500 Index does not reflect the U. S. economy and has had deficiencies now and in the past.
3. Historically, active managers have done better by overweighting and underweighting stocks outside of the Index. Since overweighting is bordering on excessive risk, active managers must underweight (poor performers) in order to outperform

DAVID DREMAN – DREMAN VALUE MANAGEMENT

Investor overreaction is the systematic over- or under-pricing of stocks when measured by P/E, Price to Book Value, price to cash flow, or dividend yield. It is a fact that investors consistently overvalue the prospects of the “BEST” or (hot names) investments and undervalue those of the “WORST” (out-of-favor) investments.

Research suggests that stocks will outperform or underperform for as long as 5 years or more. This research also points out, out of favor stocks, on average, outperform hot stocks by 5-6 percentage points per year. Valuation will eventually rise on out-of-favor stocks. They do not get there as quickly as investors want. This psychology is what is currently affecting investors to keep buying the overpriced markets and ignoring the undervalued markets. This will soon change.

DAVE LAWSON – MCHUGH ASSOCIATES

Indexing is popular because it offers a number of advantages compared to active separate managers. Indexing offers lower costs, lower tracking errors and lower administrative costs, both in terms of time and dollars. Unfortunately indexing also has disadvantages since it offers no scope for security selection or tax management.

Two myths are important when considering the tax efficiency of indexing/passive management. First, indexing is an easy solution to tax efficient investing and second, passive is more tax efficient than active. Neither, however, is necessarily correct.

Active management expects longer investment horizons than, for example, some index funds. If a stock is added, then later deleted from an index, it is done without any tax consideration. Active management requires less turnover which puts the return on capital taxed at the 20% versus 40% level. The other concern is if there is a sell off in an index fund, all shareholders will experience a tax liability – no exceptions.

In conclusion, I would like to point out my favorite arguments.

1. *Diversification (look on the reverse page) – Active management uses equal weighted; indexes use market cap.*
2. *Hot stocks eventually aren't hot any more and out-of-favor stocks outperform.*
3. *Tax management of assets in active management can potentially outperform indexes.*
4. *Unknown liability if there is a sell off of your favorite fund.*
5. *To repeat last quarter's newsletter --- “Utilizing both indexing and active investing is a smart approach. One thing I have learned – there isn't any one secret to superior investment returns.” Diversify but don't over diversify.*

IF YOU WOULD LIKE A COPY OF LAST QUARTER'S ARGUMENT FOR INDEXING, PLEASE CALL.