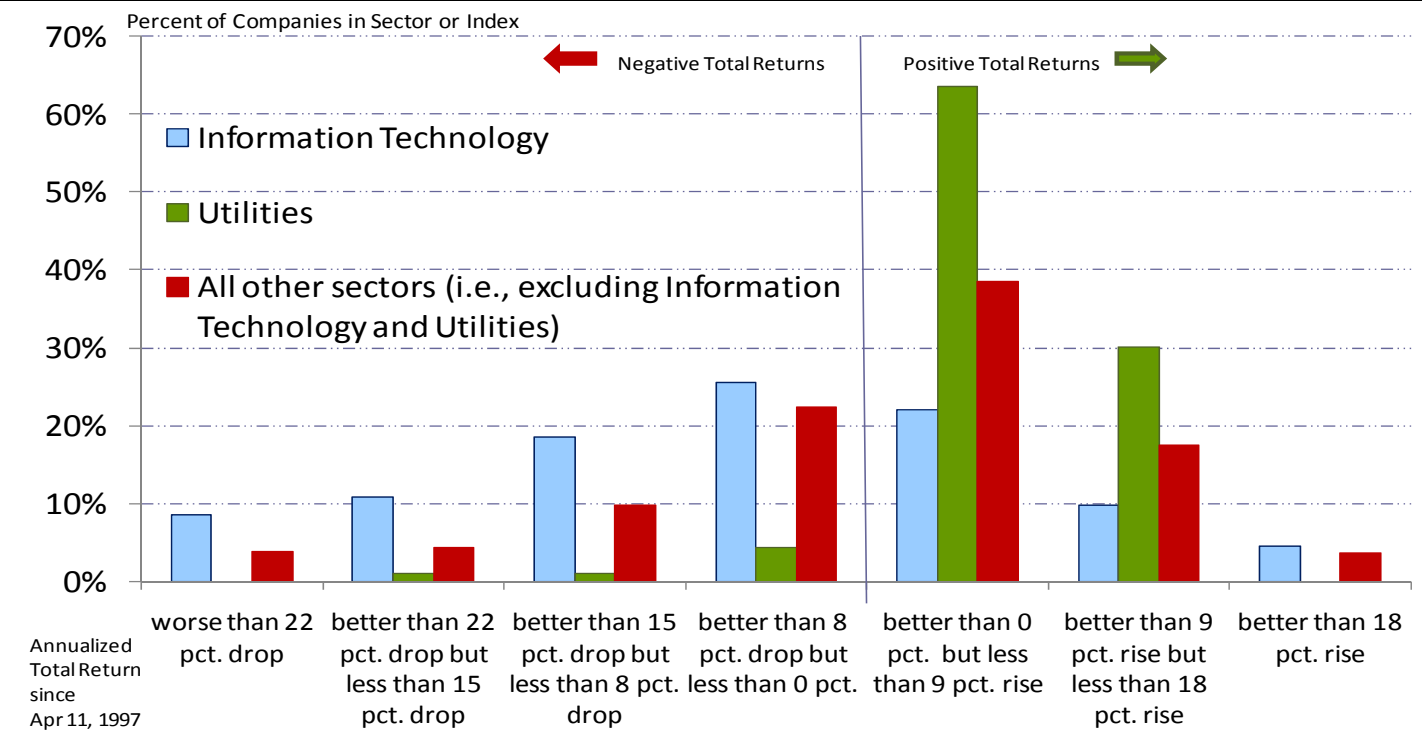


Investors Should Resist the Urge to Give Up on Common Stocks

- The Dow Industrials and Standard & Poor's 500 indexes have broken through their 2008 lows, reaching levels not seen since 1997. The brutality of this bear market has apparently caused some investors to give up entirely on the idea of owning stocks, concluding they have made no progress in the past dozen years. According to Ryan ALM, Inc. the return on Treasury bills was nearly +60% -- about +3.8% per year – since April 1997.
- Berkshire Hathaway (NYSE: BRK/A, \$78,600) has risen +113% (+6.6%/year) since April 1997. Keep in mind however that past performance is not an indication of future results. In his annual letter to shareholders, CEO Warren Buffett says “the investment world has gone from underpricing risk to overpricing it,” and “Whether we’re talking about socks or stocks, I like buying quality merchandise when it is marked down.”
- Have common stocks actually performed as badly as it seems? Of course, it depends on what an investor owned, and what one includes when measuring the returns. Dividends alone on the Standard & Poor's 500 provided a return of +22% since April 1997, about +1.7% per year. For the Dow, the yield has been even higher.
- The nature of an investor's portfolio is even more important to its success. Indexed portfolios have become increasingly popular since they first appeared in the 1980's, as more investors focused on efficiencies and costs. **But some of the popular indexes may be too concentrated in the highest capitalization stocks, putting investors at the mercy of some nasty surprises like the collapse of technology stocks in 2000-2002 and the financial stock meltdown that began in 2007.**
- When many observers refer to the “market,” they are usually referencing the S&P 500 or the Dow. We have illustrated in a prior issue (see “The Week,” February 2, 2009) how closely these two indexes have tracked each other. But we believe investors would be better informed if they instead considered the “market” to be a broad, equal-weighted index like the Value Line or perhaps the S&P 500 Equal Weighted index. In our opinion, investors should regard the “classic” S&P 500 as a specific portfolio with a heavy bias toward large-capitalization stocks. Sometimes, that bias can be a benefit ... but it can also be a detriment, as we saw in 2000 and 2008.
- The concept of the S&P 500 as the “market portfolio” has been supported over time by many in academia, who point out that the index traditionally represents over 70% of the entire market capitalization of U.S. listed companies, and thus must be a representative sample. We concur, but suggest that investors (and their portfolio managers) monitor the participation of issues underlying any indexed investment, to determine whether some divergence(s) may suggest a shift in strategy that is defensive and designed to try and protect against losses.
- If the S&P 500 is persistently outperforming the Value Line or other equal-weighted index, we should try to determine why, to see whether some sector or another is being over-inflated — like technology stocks in 1999. Likewise, if the S&P 500 is lagging other markets, the reasons for the underperformance should be investigated to see whether the reasons are structural or cyclical, perhaps indicating an opportunity.
- We analyzed the performance of 2410 U.S. common stocks that were listed continuously from mid-April 1997 through February 27, to see what lessons one might glean about investing over the intermediate to long-term. We knew that we would find a large number of stocks that had performed quite well, despite the disappointing performance of the indexes. Unfortunately, the cap-weighted nature of the popular indexes tends to obscure the plurality of issues. We also suspected that certain sectors had performed much better than others.
- Investors have come to recognize risk as the volatility of financial assets, or their tendency to bounce around a central path of value created over time. For any given rate of return, lower volatility is better, as holders feel more confident they can redeem (or invest more) at a fair price. Our historical analysis allows a look into another kind of risk, called “dispersion risk,” that can affect investors' portfolios in a meaningful way.

Beneath the Surface of the Popular Indexes, Some Important Lessons About Stock Investing (Indexes Sometimes Overstate or Understate the Underlying Economic Value Generated by Companies)



Note: Based on analysis of 2410 common stocks from April 11, 1997 through February 27, 2009. Total return includes reinvested dividends. Returns do not include fees, commissions or expenses which would have a negative impact on investment results. There is no assurance companies will continue to pay, or increase their dividends. Source: FactSet.

About 57% of the 2410 stocks provided a positive return including dividends over the nearly 12-year period; the median return was +25% (almost +2% per year). The median returns by sector varied from a loss of -4.4% per year for technology, all the way up to a gain of +6.8% per year for utilities. The distribution of returns in these two sectors — and the remaining sectors as a group — are shown above.

Note how the spread of the distribution (a.k.a. “dispersion”) of returns in technology is much wider than utilities, and the remaining sectors. Indeed, 5% of the technology companies were in the top category. Is this sufficient reason to overlook the large numbers of tech stocks in the worst categories? We do not think so. But we have to be careful — as investors — to avoid that strong human tendency to highlight our successes and underplay our failures.

Meanwhile, the utility stock returns are concentrated tightly around the median annual return of +6.8%. About 7% of the stocks fared significantly worse, but more than four times as many exceeded the average return by a meaningful amount. While many investors consider utility stocks to be too conservative, results like these might change some minds.

Tom McManus

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