The Index Investor

Why Pay More for Less?

Looking Back at 1999

Most popular market averages achieved significant gains in 1999. The Dow Jones Industrials gained 25.2% and the S&P 500 gained 19.5% -- the fifth consecutive year both indexes have enjoyed double-digit growth. The Nasdaq Composite was up an unbelievable 85.6%, half this gain coming after the index reached 3000 on November 3. (This was the best performance ever by a U.S. stock index in a single year). And the Russell 2000 (the most popular small-cap barometer) gained 19.6%, slightly edging the S&P 500.

The Lipper Mutual Funds Quarterly section of the January 10 issue of Barron's reported the following winning sectors for 1999: In the U.S., the average science and technology fund was up 134.77% for the year, the average telecommunications fund was up 73.78%, the average growth fund was up 52.34%, and the average natural resources fund was up 30.68% for the year.

Growth significantly outperformed value in 1999. Large-cap growth funds gained 38.09% for the year vs. 11.23% for large-cap value funds. Mid-cap growth gained 72.86% vs. 9.33% for mid-cap value, and small-cap growth increased 62.63% vs. 6.33% for small-cap value. A good deal of the growth vs. value discrepancy was driven by the performance of Internet, telecommunications, and general technology stocks. It was not a good year for value investors, especially on a relative performance basis.

International funds also enjoyed strong performance in 1999. The average international fund gained 40.8%, more than doubling the 19.5% performance of the S&P 500. The average Pacific fund was up 92.48%, and the average Japanese fund gained a whopping 120.51% (nearly matching the performance of U.S. technology stocks). Emerging markets, which had been severely pummeled during the Asian economic crisis, rebounded strongly, gaining 70.77%. China gained 62.35%, Latin America advanced 60.21%, and Canada was up 43 34%. Overseas small-caps also performed well, with the average international small-cap fund up 75.41%, and the average global small-cap fund up 48.08%. The worst performing international sector tracked by Lipper was the European region, up "only" 24.42% (more than the S&P 500).

A survey conducted by Birinyi Associates summarized in the Wall Street Journal's January 3 Year-End Review of Global Stock Markets shows the breadth of international equity strength in 1999. 77 out of the top 100 world stock markets gained ground in 1999, with the average stock market gaining an astounding 53.95%!

Bonds, on the other hand, were a different story, suffering their second worst year since 1973. The average treasury fund was down 6.17% for the year, intermediate treasuries were off 2.27%, and high-yield bonds were up only 2.54%. International bonds in developed countries were off over 7% in 1999, but emerging markets debt gained 24.49% in tandem with the strong performance in emerging markets equities.

Bottom Line: 1999 was truly the year of "have and have-nots". Investors in technology, growth, or international stocks did well. Investors in value or fixed-income securities were not happy.

Model Portfolios Performance Update

The spectacular returns that have characterized the US equity market continued to be very narrowly based through the month of January. For example, you cannot say that technology sector as a whole has driven the market; in reality, only a few technology stocks have enjoyed spectacular gains, while the majority have struggled to maintain their head above water. Despite these conditions, retail investors continue to invest substantial amounts of money into technology mutual funds. This raises the question: is the US equity market as a whole overvalued? This is the subject we shall address in an upcoming newsletter.

Our high/medium/low risk portfolios kept pace with their benchmarks for the month of January. Our high-risk portfolio is down 3.9% year-to-date vs. -4.0% for its 80% S&P 500 / 20% Lehman Total Bond benchmark. Our medium-risk portfolio has lost 3.4% vs. -3.1% for its 60% S&P 500 / 40% bond benchmark. And our low-risk portfolio has lost 1.5% vs. a loss of 1.2% for its 20% S&P 500 / 80% bond benchmark. Losses are driven by the decline of the large growth asset class (down 6.7%) and small-cap value (down 5.2%).

Our target return portfolios are down slightly due to European equities (down 7.1%) and the US total stock market asset class (down 4.2%). Our 12% target portfolio is down 4.4% through the end of January, our 10% target portfolio is down 4.0, our 8% target portfolio down 3.3, and our 6% target portfolio is down 1.5%.

1999: The Year of Tech

1999 was truly the year of technology investing. The Nasdaq surged 85.6% vs. 19.6% for the S&P 500. (Over the past decade the Nasdaq has gained 795% vs. 317% for the Dow Jones Industrials). 14 of the stock market's 15 best performing big stocks were direct plays on either mobile communications or on computer or Internet technology. The 100 top performing mutual funds of 1999 (out of 7,000 U.S.-registered mutual funds) all returned over 100% for 1999. All of these funds were technology funds, small/mid-cap growth funds with a high technology content, or Japanese funds. The top 20 funds each returned over 200% in 1999!

Barron's January 10 Lipper Mutual Funds Quarterly section reported that "since Lipper began tracking mutual fund performance in 1960 just 3 fund categories have ever averaged a return of 100% or higher in a calendar year. Two of these happened in 1999 when technology funds averaged 134.77% and Japanese funds averaged 120.51%. The other occurrence was gold funds returning 155.42% in 1979".

The Russell 2000 growth index was up 29% for the year while the Russell 2000 value index was down 6% -- a differential of 3500 basis points skewed by technology and Internet stocks. William Nasgovitz manager of the Heartland Value Fund lamented in the January issue of AAII Journal: "Internet and technology companies on average are selling at about 10 times sales, and half of them don't have any earnings. In fact, the way to have make money in 1999 was to buy companies with no earnings -- if you would have bought only the Russell 2000 stocks with no earnings, you'd be up 45%!

Technology performance also helped drive the S&P 500's 19.6% gain in 1999. The average stock in the S&P 500 rose only about half as much as the index's overall gain.
Bottom Line: To the extent technology is truly changing the way we live and impacting American productivity, technology investing should produce attractive returns. On the other hand, both the number of new technology and Internet funds and dollars invested in technology is exploding, increasing the risk of major losses for technology investors.
Broadly diversifying technology investments and capping technology investments at a fixed percentage of investor portfolios will most likely be a prudent course of action in the coming decade.

And The Year of Indexing…

Our Directory of Index Investments contains well over 100 index mutual funds and exchange-traded securities spanning multiple asset classes and world geographies. Index investing is exploding. Spiders, WEBS, and other traded index securities are proliferating on the American Stock Exchange. Index-oriented fund companies such as Vanguard may soon be forced to offer exchange-traded products or risk losing assets.

Barclays Global Investors will soon launch 51 new index securities which will be traded like Spiders, Diamonds, and WEBS on the American Stock Exchange. The new securities include domestic and international S&P, Dow Jones, and Russell indices.

E*Trade has partnered with Barclays to introduce 6 new mutual funds, including Internet and technology index funds based on Goldman Sachs indexes.

Indexing will continue to proliferate overseas as Vanguard, Fidelity, and other fund companies attempt to duplicate their U.S. indexing success, and international fund companies become increasingly enamored with indexing's performance and share gains in investor assets.

Bottom Line: Indexing will continue to gain momentum as the best way to gain asset class diversification at the lowest cost. Index investing vehicles will also continue to grow as new funds, exchange-traded securities, and global asset class indexes become available and more widely covered in the financial press. The next decade will see an explosion in index investing by retail investors.