THE PROBLEM WITH LOW NUMBERS

I note the beginning of the silly season, a phrase once used to deride the rumors about which Formula 1 driver was moving to some other team, but which I think should refer to mutual fund reporting. I have only a few seriously negative things to say about funds – some of my best friends own them and a few even work for fund companies . . . .

My issue is with the reporting of performance. Having just calculated results for my clients (just fine, thank you) and reviewing the results of funds used by a few of my clients, I thought I would supplement my year-end economic outlook with some reminders about mutual funds.

They are useful if you have less than 1/2 or 3/4 of a million dollars to invest, but they can be expensive – regularly 1.4% to 2.5% in annual fees and, as I hope you will see, that's too much.

Of greater concern however, is the fact that they buy and sell continually – often turning over the portfolio completely one or even two times a year – a process I have yet to figure out, though I have some libelous suspicions. This constant trading or churning makes it very difficult for any gains to be long term – meaning taxed at a maximum of 15% and, in fact, it often produces tax penalties crossing 30% for participants.

The numbers, then, need to be discounted. When Fidelity or Vanguard or whomever report, with full page ads in large bold type, that they achieved, let's say, 12%, my skepticism makes me knock off 1/3 for taxes, state and Federal. This is why I prefer individually managed portfolios. Time spent picking stocks and holding them through an economic cycle or two, weathering occasional management lapses, strikes me as far more prudent – and more efficient, especially when the numbers are low as were last years'.

But there's more. Along with the numbers comes a string of stars granted by Morningstar. A whole separate paper could be done on their methodology, but take this one tidbit: A poor absolute performance number, i.e. low for the type of fund, can nonetheless gain a 5-Star rating if the risk taken was low – and folks who use Stars to buy funds should remember that. Last, and perhaps not least, is that <u>all</u> mutual fund companies quickly close poor-performing funds the better to maintain the public image. Therefore, all industry summary performance data such as "average growth stock funds performance" has what is commonly called survivor bias – over time the results are biased upward as the bad funds are closed and data is thus dropped.

Okay – I feel better. On to the economy and its step-children, the Fed and mortgage bankers. The hard part here is to not be repetitive – we all read and hear the daily news. The problem is, to me, the tendency to report "averages" – something I've obsessed on before. I am indebted to David Malpass at Bear Stearns for the following two thoughts about housing, for example:

1) The Case-Shiller U. S. National Home Price Index peaked in 2006-Q2. In the preceding 5 years it had risen 69%. Since the peak, it has fallen 6% nationwide – supporting a point I made some time ago about overall modest house price declines. Anything up nearly 14% a year that gives back 5% or even 15% makes sense to me. Look for a bit more decline, but keep it in context.
2) The Mortgage Bankers Association cites the fact that the big declines are where there were big gains – Sacramento, Sarasota, Las Vegas, etc. They note that from what they calculate the peak to be (2005-Q3) to date, median home prices rose in 98 of 143 metro areas.

The point I'd like to make about housing beyond the already obvious is that the median price – the price that is midway in a rank from highest to lowest – has had a net decline in only nine metro areas – and they were all in Michigan, Ohio and Indiana. This surprised me, too.

And what of delinquencies? In the 80s, they averaged (sorry) 5.3%, 4.4% in the 90s and 4.7% in this decade. In the last 3 quarters they hit 5.2% and are now 5.6%. In context, a different view and this time heavily led by the sub-prime-liar loans fiasco. Foreclosures? Florida and California are 45% of what is expected to be a 1,000,000 count for 2007. Starts? Florida and California are 34% of the decline – again – the overbuilt, sub-prime, spec-build markets.

Housing, David proposes, doesn't cause recessions, but he notes previous housing slowdowns arrived with tight monetary policy – a factor that can seriously weaken the whole economy. We do not have tight money and, in fact, easing is occurring, but it will not save the house speculators – both amateur and "professional."

I hope you see that localized events are being extrapolated into the whole country and, lacking a frame of reference, make us think they are causing a recession. So: Recession at 20% probability. Unemployment was long in the 4% world and is now 5%+. Again – unemployment is an average – for example, young black males are over 35% unemployed and rising sharply – but firms added 1.3 million to payrolls over the last 12 months.

Inflation: My best indication is what the bond traders do. Nominal inflation is running 3.5% or so, TIPS – the inflation-indexed Treasury instruments – are at 1.5% to 1.6%, so expected inflation looks like 2.2% or so – not a major issue.

Arthur Laffer (who moved from southern California to Nashville) contends there is no lack of capital – no "credit crunch." He notes, among other pluses, the massive amount of Greenspan dollars still awash in the economy, foreign cash investors, steady corporate loan growth and Fed help from their liquidity injections to the banks is working. But the Fed has to lower the Fed Funds rate to keep it going. I see 2 big cuts coming.

Corporate profits will have to weaken a great deal to move my recession probability. Earnings did decline in Q3 and probably Q4 of 2007, but a large part of this was financial

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institutions and that story is well known, i.e. it's already in stock prices. Consumer spending is slowing and will be weak for at least a few quarters. Gas prices, at current levels, are equivalent to a tax hike – a large one – and yet consumption is steady.

Consumer sentiment is a strange piece of data. Long ago a marketing professor preached to us that what people say they will do – say in a car-buyer survey – and what they actually do are regularly worlds apart. I, for one, think the unemployment rate is more relevant to consumer spending than sentiment indicators and, again, it is hurting segments of the country, not the whole country. We'll see.

The stock market whipsawed a lot of "investors" this past year. My clients did not cut and run for which I am thankful – the market was up last year in spite of some wicked swings. Long-term investors will have a tough first half but I see the market up in 2008 about the same – 6%. The problem with low numbers is that <u>everything</u> matters: Keep your broker costs, turnover and such low; keep your eye on achieving long-term tax rates. We have benefited from low inflation, low unemployment, low interest rates, low oil prices (inflation adjusted, a deal) and low mortgage rates. Any move from abnormally low numbers is bound to create a "sky is falling" mentality so dig into the "averages" and anticipate upward moves in all these elements to what I believe will be more typical ranges. Oil, I think, has peaked; it's the exception. Gas is very cheap . . . if it was expensive YOU would buy a Prius (called a Pious out here). Watch what the consumer does, not says . . .

If you have grown weary of your advisor's trading activity, excessive mutual fund purchases and constant pitches for insurance and additional financial products, welcome to the new "service" industry – frankly, I'm disgusted with what has happened to the money management profession. Next time, maybe I'll talk about "wrap" programs or the difference between client types. Now I feel better. Have a great 2008!

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