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## Eureka! Lucid Data!

Wealth Planning & Management announces the formation today of ELUCIDATA, a nonprofit, barely existing organization of one person. Its impossible goal is to reduce the availability of stock market statistics, to battle data miners, to deter comparisons, and to promote the quiet, simple, anxiety-free lives of persons who do not read tables and graphs.

The amount of securities markets data is staggering. History never has known so much. Securities markets statistics in one day's *New York Times* exceed by a thousand-fold the ability of human minds to absorb, to analyze, to understand. Computers screen the data against preconceived criteria, thereby manufacturing even more "facts," themselves then subject to further analysis. Examples:

- Dozens of analysts make earnings forecasts (the future trend of earnings) on thousands of stocks. Organizations accumulate forecasts, then analyze the trends of forecasts, which is to measure the trend of a trend. The trend of a trend is, in turn, a new "fact."
- Accumulators gather all kinds of data. They are both "information manufacturers" because they create new forms of information, and "information engines" because they use new information to drive decision making.
- Among new facts of the past 50 years are "betas," "standard deviations,"

"correlations," and "alphas." Meanwhile, new averages and indexes appear frequently, many known by the number of components, such as *The 1,000*, *The 2,000*, *The 5,000*, and so on. Existence of averages and indexes prompts creation of comparative statistics to answer the question "How have I done compared to 'the average?'"

- Performance data on mutual funds is voluminous, and the messages of that data change monthly. The messages also vary by source. *Forbes*, *Bloomberg*, *Morningstar*, *Consumer Reports*, and countless others provide information in different formats using different rating criteria. Some of these sources provide lists of "All Stars," but seldom does a fund remain on the All Star list more than a year or two. The star of today is the dog of tomorrow. To an eagle flying high, mutual fund information would appear like a constantly changing forest in which the location of his nest changes daily, chaotically, unpredictably.

Most data is old. Data in newspapers is a day old. It represents what the market did yesterday, or during a period selected by the editors. Professional data usually is weeks old. Consultants deliver performance information to institutions between two and six weeks after the close of the period measured. Mutual fund information is weeks or months old on receipt, and some important data, such as the names of heavily weighted

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## Eureka!, *continued from page 1*

stocks in a mutual fund portfolio, might be years old, though printed in this month's mutual fund review.

Since all data is old, how should a portfolio management firm (such as Wealth Planning&Management, LLC, publisher of this newsletter), present results to its most important constituency, its loyal clients? How should we provide data that elucidates? Here is one answer (from our July letter to clients):

"Performance information is rate-of-return statistics for given periods. Presentation of performance statistics is integral to *institutional* investing. Retirement plans, endowments and foundations, among others, maintain detailed data about their time-weighted total rates of return, and about the rates of return earned by each manager responsible for a portion of the portfolio. Usually, professional independent consultants provide the data. In addition, the consultants offer comparisons to standard indexes, as well as to peer group members. With the addition of risk information, quarterly reports provided to institutions run between two and twenty pages, and they include colorful graphs and charts. Utilizing the data, institutions evaluate investment

policies and make comparisons that lead to the hiring or dismissal of money managers.

"As a longtime student of institutional investing, I committed to providing rate-of-return information to clients. Hence, in late 1996, I purchased a portfolio information system to retain data and to render performance information each quarter. Since modern performance presentation standards require computing a return each month, then linking the returns, WP&M computes values each month. The process is time-consuming, but the information is useful both for computing returns and for making investment decisions."

"WP&M's performance information has varied compared to indexes, often favorably, other times not. In April, for example, many portfolios were up over 10 percent (an approximate 120 percent annualized rate), an aberration, but one that offset slightly unfavorable data through the end of March. The volatility of results, and the constantly changing relationship to standard indexes, prompted me to think about presentation of performance information. Here are conclusions:

- Most providers of investment services to individuals do not report rate of return. Most statements rendered by bank-sponsored asset management groups, such as trust departments, as well as custodial statements of brokerage firms and mutual funds do not present a performance number. Mutual funds and companies providing mutual fund information compute and distribute rates of return for standardized periods. However, this information is not provided for real situations, such as for the person who purchases a fund on Janu-

ary 24, or sells a fund on November 11. I wager that no individual or institution earns the published standardized rates because no one both purchases and sells on the prescribed dates.

- Performance information is fickle. For example, data provided by WP&M for the first quarter covered the period December 31 to March 30. With the cutoff date at April 15, two weeks later, performance of certain stocks in WP&M portfolios produced a much more favorable result. Another example occurred at the end of the second quarter. On June 30, the last day of the reporting period, an important stock in many WP&M portfolios dropped almost 4 points, thereby impacting the second quarter performance report. However, one day later, July 1, the stock recovered most of the loss. Hence, a rate of return calculation through July 1 is different than the same calculation through June 30. How fickle can we get?
- Standardized performance information is not directly related to net worth. Payment of taxes, or utilization of tax deductions, especially arising from capital gains and losses, produce a different effect on net worth than on the rate of return of a portfolio.
- Though fickle, rate-of-return information causes investors to change investments, investment styles and investment providers. Such changes are common during bear markets. Generally, the expenses of such changes, and the opportunity cost of selling low and buying high, exceed benefits.

What is the bottom line? It is this.

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### Thoughtful Wealth Planning&Management

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## Our Understanding of Events. . .

often is a function of our gut reaction to information. Our reaction, in turn, varies by how information is presented to us. Since an accurate assessment of stock market information is crucial to investment success, we must be sure that our impressions are correct.

To demonstrate the power of how information is received and processed, lecturers ask audiences “Which kills more people, heart disease or automobile accidents?” Commonly, about sixty percent of the audience will pick automobile accidents. Of the responses pointing to heart disease, most believe that the ratio is two to one or less. The accurate statistic is seventeen to one, heart disease. [In 1996, 733,361 persons died of heart disease, or 134.5 per 100,000. Heart disease is the number-one killer. In 1997, automotive accidents killed 42,420 persons, or 16 per 100,000.] The reason for the misimpression is that news sources prominently report accidents, but bury health statistics in back pages.

Another widely held misimpression is the cause of the existence of “cancer clusters,” communities which have concentrations of cancer cases that “must be caused” by an unknown, specific carcinogen in the environment. Unfortunately, scientists have not been able to confirm such causes. In a story in the February 8, 1999, *New Yorker*, California’s environmental health investigator said that of the hundreds of studies “not one has convincingly identified an underlying environmental cause.” Nevertheless, citizens believe that a cause exists, and they allege all sorts of personal, economic and political motives for failures to find it.

The article goes on to ask:

“If true neighborhood clusters—that is clusters arising from a common environmental cause—are so rare, why do we see so many? In a sense, we are

programmed to: nearly all of them are the result of almost irresistible errors in perception. . . called the Belief in the Law of Small Numbers. People assume that the pattern of a large population will be replicated in all its subsets. But clusters will occur simply through chance.” The misinterpretation of random events produces beliefs that a roulette wheel is rigged if red comes up

*“Concentration of success in the few always falls within the rules of chance.”*

many times in succession, that athletes have winning and losing streaks, that some military pilots (“aces”) have special talents, and that a few famous investors, such as Peter Lynch, John Templeton and John Neff have extraordinary capabilities to predict. But, concentration of success in the few always falls within the rules of chance. Random occurrences produce concentrations of events that seem abnormal, but are statistically normal. A favorite illustration is the orangutan theory of coin tosses. If 200 million orangutans toss coins, 100 million (or so) will turn up heads. After a series of tosses in which tail tossers are eliminated, 10 orangutans will be left. People then perceive unusual skills in the remaining ten, and CNN seeks them out for interviews.

Every observer of every event faces the irresolvable conundrum: Do some people (famous investors?) have unusual skills, or are they merely the beneficiaries of normal, random allocations? We never will know. Therefore, the successful should be humble, and the ambitious-but-moderately-successful can take heart, for they still

have a chance to reap reward from future, random events.

## Which Fund To Buy?

The July-August edition of a national investment magazine reported results of “Domestic Institutional [Mutual] Funds” that demonstrate the vagaries of performance data.

The report included 13 columns of data: category; percentage rank in category; one-, three-, and five-year returns; expense ratio; turnover ratio; standard deviation; beta; alpha; Sharpe ratio; best fit index, and best fit r-squared. In the eyes of different analysts and investors, each column has different importance. While Joe believes that the turnover ratio is key, Betty places more significance on the expense ratio.



The data is confusing. The number one fund had a one-year record as of April 30 of 34.63 %. However, funds ranking 161, 149 and 125, among others, had better records for five years. The number one fund had a turnover ratio three times that of the number 6 fund, but less than funds 2 through 5. The expense ratio of number 15 was half that of number 1. In theory, a higher standard deviation means higher risk (higher reward?), but the 159th fund had a standard deviation of 29.81 compared to 20.75 for number one.

Which data is important? Which statistic leads us to acquire the fund having the best *future* performance? If you know, let us know. Call 317-228-0800 with your thoughts.

## Eureka!, *continued from page 2*

WP&M will continue to maintain information necessary to compute rates of return. However, we will not *routinely* distribute this data. Of course, we will continue to report account holdings and values each quarter. Meanwhile, clients may ask us for detailed performance (rate-of-return) information at any time, and we will be able to respond to specific requests by designing a report that contains the requested information. Also, we can compute returns over different periods. By responding to specific requests, we will be able to discuss the meaning of the information provided. Let us know what you need. We will provide it.”

Our goal is to distribute information that helps clients to improve their net worths. Growth in net worth arises from acquiring quality securities, controlling taxes by carefully monitoring realized gains, and reducing expenses of investment administration. Popular, standardized statistics do not include net impact on net worth. Sponsors of indexes, for example, do not reduce the rate of return for capital gains taxes theoretically paid when a stock is removed from the index. In fact, most investors do not measure the effect of taxes when realizing gains, and most investment firms, including WP&M, presently do not have the computer power to measure the opportunity cost of paying taxes.

Despite inherent inconsistencies in any array of data, someone, somewhere, will use the information, either to mine and to manufacture new “facts” or to drive decision-making through a theory based on the data. The impractical, im-

possible goal of ELUCIDATA is to fly swat the useless data and theories, and to search for concise information that makes a difference.

### To Rent or Not To Rent

A paragraph in our April issue suggested that leasing real estate might provide superior financial results to purchasing. One client’s disagreement was published in June. Here are additional comments:

From Sharon: “Choosing to buy or to rent is fundamentally based on two factors: 1. One’s identification with space and its control—how upsetting is moving yourself and your dependents and belongings within 30 or 60 days at the dictate of someone else? 2. One’s identification with the land and its shelter—what opportunities might you miss in not planting or tending your own spruce or cherry trees, not designing your own drapes or custom-built cabinets?”

From Keith, an investment professional: “[A recent widow told me that her husband] calculated that it was a lot less expensive for them to live in an apartment [instead of their own home]. Having been brainwashed into thinking that ownership was always better than renting, I immediately thought that her husband was not too sharp. Then she showed me her net worth statement. That moment caused me to reconsider. I was then a renter and a dreamer of being an owner. Today I am an owner and a dreamer of being a renter. The cost of added utilities, property taxes, homeowners insurance, fer-

tilizer. . . and the joy of maintenance definitely take the luster off of home ownership. After nearly seven years in a home in one of the fastest growing counties in the country, after netting out basic maintenance expenses and permanent additions to our home, the annualized appreciation rate is less than three percent. I am not quite sure what it would have been in a slow growing community. Keep challenging the minds of your readers.”

From John, your editor/commentator. My wife became upset upon hearing arguments that home ownership is not the best way to improve net worth. She experienced one of those awful emotions: “maybe we made a big mistake.” No, I said. We love our home. We love our family. We love our lifestyle. For this, we paid a price, and it has been worth it.

### To Borrow, Or Not. . .

A story in the July edition of *Consumer Reports* is a must-read. Starting on page 12, it provides seven strategies for borrowing, which are:

- Keep borrowing in its place.
- Know good debt from bad debt.
- Set your own credit standards.
- Understand what credit costs.
- Credit cards—when to hold ‘em and when to fold ‘em.
- Keep your credit record clean.
- Get rid of any excess debt.

For back issues of *Consumer Reports*, send \$5 for each to Back Issue Department, *Consumer Reports*, P.O. Box 53016, Boulder, CO 80322-3016.

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