Feature

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A Whole Lot of Bull$*#%!

By Robert Markman
Photograph by Robert Wright

Blowing away the half-truths and flimsy data that cripple mutual funds

"When somebody persuades me that I am wrong, I change my mind. What do you do?" --John Maynard Keynes

I am an investment adviser. I began working in the mutual-fund world in 1981 and, in 1988, went into business for myself, founding Markman Capital Management, based in Minneapolis. Today, my firm manages more than $200 million. Like all money managers, I had my good years and not-so-good years. But I grew increasingly uncomfortable with the way I was executing my fiduciary responsibilities. There were just too many times when my results did not match my own expectations. This occurred too often to be chalked up to normal vagaries of the markets.

And it wasn't just me. Many of my most experienced and respected peers were doing worse than I was. The conventional explanation was that we advisers were guilty of nothing more than erring on the side of caution. Our techniques would pay off when the markets turned rocky. But our bluff was called: Several times in the 1990s, the markets turned rocky. Several times, our techniques didn't pay off. Lag on the upside, get hurt on the downside. How could this happen? How could I and so many of my fellow money managers, most of us intelligent and sophisticated people of widely differing temperaments and styles, all be bungling at the same time and in roughly the same way?

To answer that question, I embarked on a top-to-bottom review of what I was doing and why I was doing it. I re-examined my tactics and strategies and started demanding empirical evidence to back up what had become quasi-religious dogma. I found, much to my chagrin, that there was no proof for much of what I had taken for granted as a money manager. The evidence forced me to conclude that:

1) Under the tyrannical lash of modern portfolio theory and the efficient frontier, the sensible practice of portfolio diversification has been pushed to illogical extremes. As a result, investors have been lured into using one class of stocks to hedge against another class of stocks, a move that is doomed to failure.

2) The conventional wisdom that small-company stocks will outperform large-company stocks is false.

3) The conventional wisdom that international investments can help reduce risk and increase return is false.

4) Volatility and risk are not equivalent. Equating the two leads to short-term tactical moves intended to reduce volatility. Instead, these moves wind up penalizing long-term performance.

Or to put it another way, it's a whole lot of nonsense. Much of the multi-trillion-dollar investment industry is built on half-truths, incorrect interpretations, flawed data, unrealistic expectations, and absurd contradictions. No wonder portfolios based on accepted doctrine have not produced the results intended.

Having reached these unsettling conclusions, I was faced with the question of what to do next. I could sew the patient back up, so to speak, pretend I didn't see what I saw, and go on as before. Or I could take my new insights back to the drawing board and try to construct an investing strategy and methodology supported by real-world evidence. I chose the latter. This article details both what I found wrong and my attempt to devise a better, more realistic way to invest.

I have come up with an approach that I've used for the past year or so to manage the Markman Multifunds, which are diversified no-load-fund portfolios. Since their inception on February 1, 1995, through November 30, 1999, the Markman Multifunds posted the following annualized total returns: Aggressive Allocation, 24.2 percent; Moderate Allocation, 19.35 percent; and Conservative Allocation, 14.66 percent. Over the same time span, the Standard & Poor's 500 Stock Index returned 27.48 percent. In the 12 months ended November 30, 1999, as I have implemented my new approach to investing and weeded out the weak sisters from the three portfolios, the Aggressive portfolio has returned 47.36 percent, the Moderate has returned 30.39 percent, and the Conservative has returned 21.12 percent. The S&P 500 has returned 20.92 percent in the same period.

Before I can describe my new investing strategy, I need to lay bare the sloppy numbers and logical inconsistencies that make the old approach useless at best and dangerous at worst. I also need to admit at the outset that I could not have written this article if I hadn't made the same investment mistakes that I criticize here. Just about every myth I expose, every technique I show to be dangerous, every bit of conventional wisdom I shoot holes in, I too practiced diligently at various times.

When the Solution Becomes the Problem: Asset Allocation and Diversification

"There is no sadder sight in the world than to see a beautiful theory killed by a brutal fact." --Thomas H. Huxley

Asset allocation and diversification--the foundation concepts of mutual-fund investing--are ironically the source of the industry's dysfunction. Both concepts began as simple, commonsense approaches to portfolio building. But they have been misused in a way that can jeopardize an entire investing program.

What could be more simple or commonsensical than the injunction not to put all your eggs in one basket? Diversification is simply that wisdom applied to the realm of investing. For the same reason that a single basket of eggs is imprudent, a portfolio of a single stock is very risky; if the company issuing the stock does poorly, an investor has nothing to fall back on. This kind of risk--the risk associated with how a particular company may fare--is called business risk (also referred to as unsystematic risk).

To reduce business risk, an investor buys several stocks with the idea that, if one company falls on hard times, others may do well. In a classic example, owning the stock of an oil company can reduce the business risk of owning an airline stock. In theory, if energy prices go up, negatively affecting the energy-dependent airline, the oil company benefits. The advantages of diversifica-tion in a stock portfolio can be achieved with relatively few stocks. Statistics show that spreading the risk over 12 to 18 stocks eliminates some 90 percent of the business risk (assuming, of course, that all the stocks are not within the same industry).

The other type of risk to a portfolio is called market risk, or systematic risk. This is the risk associated not with any particular company but rather with the market as a whole. This risk cannot be diversified away by investing in more stocks, because when the market as a whole goes down all stocks have a tendency to be negatively affected. This is the part that investing theorists leave out when they urge investors to use, say, small-company value stocks to hedge against declines in large-company growth stocks.

There's a crucial difference here: With business risk, the worry is that a company could go out of business. With market risk, the chief concern isn't the viability of an investment but its volatility. Looking at risk as a measure of volatility (usually over a fairly short period) was first introduced more than 40 years ago by Harry Markowitz, who laid the groundwork for what we now know as modern portfolio theory. Over time it has become the most widely accepted concept in all of investing. And also the most tyrannical and destructive--and wrong.

According to modern portfolio theory, an investor who wishes to reduce market risk must own assets that respond differently to the same set of economic conditions. The measurement of how one investment acts relative to another is called its correlation. Two investments that react much the same way are said to have high positive correlations. If they react in ways that are not all that similar, they have low correlations. If they react in exactly opposite ways, they are said to be negatively correlated.

Along with correlation, the other keystone of modern portfolio theory is the concept of the asset class. An asset

class is any broad category of investments that have similar characteristics and correlations. Stocks are an asset class. Bonds are an asset class. Cash is an asset class. Money managers try to achieve a mixture of different asset classes that, because of their low (or negative) correlations, will produce the optimum combination of reward and risk.

This mix-and-match process is called asset allocation. When limited to the broad choices of stocks, bonds, and cash, it's a prudent exercise. If that's all investors did, or advisers advised, or reporters reported, there would be little reason to write this article. Unfortunately, the mutual-fund world has, over the past 25 years, multiplied the number of asset classes beyond all reason. For instance, some investment professionals and academics have noted that foreign stocks often move independently of U.S. stocks. Others have found that small-company stocks exhibit performance characteristics different from those of large-company stocks. Emerging markets, of course, march to their own drummer. Along with these newly discovered asset classes has come research "proving" that small-company stocks outperform large-company stocks, that foreign stocks hedge the downside risk of U.S. stocks, that emerging markets cannot only reduce the volatility of a domestic portfolio but increase the upside potential as well.

Armed with this research, investors are assured they can now blend several asset classes together in a mixture that will reduce their short-term volatility and maintain--and perhaps enhance--their return potential. The return-and-risk patterns of various blends can be plotted on a graph that shows the risk/reward trade-off of each mix of assets. This graph, which resembles Nike's "swoosh" logo turned upside down, is called the "efficient frontier." It purports to show where the maximum level of return lies for any given level of risk.

With its scientific tidiness, the efficient frontier has become the standard by which most knowledgeable and sophisticated practitioners operate. There is only one problem. The efficient frontier doesn't exist. That thousands of intelligent investors have been deluded into believing in a mythical and factually unsupportable construct is a remarkable example of intellectual mass hysteria.

The theory that says risk can be reduced and returns enhanced by diversifying among asset classes is based on the belief that we can determine how different investments correlate. Supposedly, this is achieved by studying historical returns in an attempt to uncover patterns; we must then assume that those patterns will persist in the future. But in fact, we're just taking it on faith that those patterns will persist. There's no empirical reason to think that they do.

The reason we can't predict the future behavior of asset classes is simple. Things change. Yes, I know the old cliche: The four most dangerous words in investing are "This time it's different." But the fact is, sometimes it is different. Correlations once thought fixed and unalterable can change almost overnight. For example, consider the correlation between two broad asset classes: stocks and bonds. It may seem unthinkable to us today, but until the late 1950s, the dividend yield on stocks almost always exceeded the interest yield on bonds. It was taken for granted that stocks were more risky than bonds, so stocks should yield more. Any occasion when bond yields exceeded stock yields was viewed as a sign that the markets were out of whack, that stocks were overpriced and due for a correction.

That's just how conventional thinkers viewed the situation when an extended run-up in stocks during the late 1950s pulled the stock yield below the bond yield. Many professional investors promptly sold their stocks, because history told them that equities were overpriced and due for a correction. But things had changed. The relationship between stocks and bonds had been transformed in the crucible of the post-World War II economy and would never again revert to its former dynamic. Henceforth, it was taken for granted that bonds would yield more than stocks. Those who insisted on adhering to the old norms stayed away from the "overvalued" equities and missed the rollicking stock-market boom of the 1960s. Even if we could, just for the sake of discussion, accept that historic relationships and correlations are accurate, relevant, and useful, we are still faced with the basic, faulty imperative dictated by modern asset allocation: Reduction of risk is equated with reduction of volatility. This misconception leads to tactical asset allocation, the worst of all possible strategies.

Tactical asset allocation is one of two broad asset-allocation frameworks; the other is strategic asset allocation. Strategic asset allocation refers to the long-term approach investors take so that their portfolios reflect their objectives, risk tolerance, and long-term goals. A strategic asset allocation would be a broad division of a portfolio into, say, 60 percent stocks and 40 percent bonds. Regardless of how the market is performing over any

short to intermediate period of time, an investor would be very unlikely to change this mix. Adjustment would be made only if the investor's circumstances changed to a significant degree.

Tactical asset allocation, on the other hand, calls for investors to tweak their portfolios according to the rules of the efficient frontier, with the goal of increasing potential return, decreasing risk, or both. Such tweaks would include shifting dollars from U.S. funds to international funds, reducing small-company exposure and buying large-company funds, and raising cash to deal with potential market risks. Investors who practice tactical asset allocation routinely eliminate or reduce their exposure to a sector with great long-term growth potential because that sector faces the risk of a short-term correction. These moves shift the focus of a long-term portfolio to the short term, creating a contradiction of purpose that can only harm results. Why are investors with 10- to 20-year time horizons shu+/-ing assets based on how they think technology stocks, for example, might perform over the next 6 to 12 months? That's crazy.

The first step on the road back to sanity is to commit to a buy-and-hold strategy. Not much of a revelation, I'll admit. Many others have said the same thing many times before. What's differ-ent about this analysis, however, is its conclusions about what to buy and hold. I'll get into specifics later. For now, though, let's look at some of the more egregious examples of hazardous allocations that result from conventional approaches to diversification.

The Small-Company Hoax

"It ain't the things that people don't know that's the problem. It's the things they do know that just ain't so." --Will Rogers

It's nearly impossible to read the financial press without coming across the statement that small-company stocks have, over time, outperformed their large-company cousins. But you wouldn't know that from the way small stocks have performed in recent years. Has the dynamic changed? Or is there something wrong with the assumptions underlying the small-stock truism?

Scott Burns, in an article in the February 1999 issue of Worth, argued that the notion of small-stock outperformance was a myth. So do I, for reasons that are related to his but not identical. (Both Burns and I use as our starting point the groundbreaking work done by money manager David Dreman, featured in his book, Contrarian Investing Strategies: The Next Generation.) The flaw in the case for small stocks traces all the way back to the original research on the subject, performed in the late 1970s by a graduate student named Rolf Banz. Starting with the year 1926, he tracked the returns of both large and small stocks over time. He divided all the stocks listed on the New York Stock Exchange into five groupings by size (quintiles). He labeled the top quintile "large caps" and the bottom quintile "small caps." He found that, even after adjusting for volatility, the performance of the smallest quintile far outstripped that of the largest.

Compelling numbers, certainly. But they're based on methodologies and inferences that are, to put it bluntly, bogus. A breakdown of the raw performance numbers shows that small stocks outperformed large stocks by an outlandish 101 percent to 17 percent from 1931 to 1935. That's odd on its face; anyone familiar with the depression years knows that those times were particularly tough on the fortunes of small companies. Just remaining in business was a questionable proposition. How is it that small-company stocks could do so much better than their equally troubled, but more financially secure, larger brethren? Simple: Those weren't really small-company stocks Banz was looking at. The true small stocks of the day were not to be found on the NYSE, even in the bottom quintile. The denizens of the bottom quintile in 1931 were mainly blue chips that had been devastated by the onset of the Great Depression. These stocks had plummeted to a fraction of their former value, relegating them to small-company status. When these "busted" large companies bounced back over the following years, they were counted as small companies that had performed tremendously. A misleading measurement, to put it generously.

Banz's study also ignored the realities of trading in the 1930s. The market in smaller stocks was remarkably illiquid during this period. The average trading volume of bottom-quintile stocks during the 1931-35 period was 240 shares a day. And that number is as high as it is only because of a handful of heavily traded issues. The median volume in 1931 was only 100 shares a day. As a result of this lack of liquidity, spreads were enormous. The difference between the bid price (what you pay when you buy) and the ask price (what you get when you sell) averaged some 45 percent. In other words, an investor who paid $10 for a stock could collect only $5.50 if

he resold it immediately. So even if you could take a time machine back to 1931 in the hope of cashing in on Banz's research, you still couldn't reap much benefit. Illiquidity, not to mention commissions, would erode much (perhaps most) of your profits.

The context for the performance of small-company stocks in the 1940s is also missing from Banz's research. From 1941 through 1945, small companies gained more than 650 percent while the largest companies had to settle for about 140 percent. Astonishing, but easily explained. Contrary to popular myth, the New Deal did not pull the U.S. out of the depression. World War II did. At the onset of the war, economic activity was still extremely sluggish and unemployment high. Companies that were formerly much larger were limping along in the bottom quintile. The war changed all that. Overnight, the "arsenal of democracy" went to work, and the fortunes of the humbled blue chips revived. So long, Axis powers. Good-bye, bottom-quintile status.

In the postwar era, the glory years for small-company stocks were 1975 to 1983, when small stocks gained more than 35 percent a year, smoking the almost 16 percent annual returns for the large stocks. Again, the discrepancy is readily explained. In addition to bad hair, bad clothes, and bad music, the 1975-83 period had bad corporate culture. Large U.S. companies, riding a quarter-century boom in which they had little or no serious competition, had grown fat, lazy, sloppy, and arrogant. And back then, blue-chip America was dominated by energy-dependent heavy-manufacturing concerns. No question about it--this was an environment in which small, nimble, and creative companies could thrive.

That era, though relatively recent, bears scant resemblance to today's world. Today's biggest corporations are aggressive, effi-cient, information-based outfits such as Microsoft, Intel, Merck, and General Electric. While we can debate whether inflation might tick up a bit as we move ahead, no reasonable observer would suggest one should plan for a renewed bout of commodity-induced double-digit inflation. Even if we did see a resurgence of inflation, its effect on the information-based large-company stocks of the 1990s would hardly be the same as it was on the industrial large-company stocks of the 1970s. Consider: The price of oil doubled in 1999, and yet inflation remained dormant.

This is not to say that small stocks will never again outperform large ones. There will probably be some periods when the best gains are to be found in smaller companies. But we can say with certainty that the received wisdom about small-stock outperformance is false and that the "groundbreaking" research that fostered this myth is an embarrassment to the entire industry.

International Investing: How to Disappoint Yourself in 12 Languages

"If I can't make money in a $5 trillion market, it may be a little bit of wishful thinking to think that all I have to do is get a few thousand miles away and I'll start showing my stuff." --Warren Buffett

Conventional wisdom tells us that diversifying internationally is smart for two reasons. First, there is the belief that international markets are generally not highly correlated with the U.S. market. Because they often zig when the U.S. zags, international investments can help reduce the volatility of a portfolio. Or so it is argued. The conventional wisdom also tells us international investments offer the opportunity for significant upside gain. But reality does not support the dogma.

Let's first ask whether international markets really exhibit low correlation to the U.S. market. Between 1970 and 1998, there have been five years when the S&P 500 had a negative return, averaging negative 11.3 percent. In only one of those five years did the EAFE (Morgan Stanley's index of Europe, Australia, and the Far East, a standard benchmark for international investment comparisons) go up when the S&P 500 fell. The average return of the five years in question for the EAFE was a negative 11.5 percent. Did someone say "low correlation"?

Oddly, while it doesn't appear that foreign markets hedge the U.S. very well, U.S. markets may be a good hedge against declines overseas. Since 1970, there have been eight years when the EAFE declined. The average return in those years was negative 13.1 percent, while the S&P 500 averaged a total return of 0.97 percent. So yes, overseas diversification may help you cushion the downside--if you live and invest in Frankfurt.

What about the special potential for gain that is touted as one of the benefits of foreign diversification? Correlations aside, if one can make more money overseas than here in the U.S., shouldn't that justify including

foreign funds in a growth portfolio? Certainly any reasonable person would have to say yes. But since 1970, there have been only three years in which as many as 60 percent of the companies outside the U.S. outperformed the S&P 500. It has happened but once in the past 20 years. Yes, it's a great big mediocre investment world out there.

Is Volatility the Same as Risk?

"If no one ever took risks, Michelangelo would have painted the Sistine floor." --Neil Simon

So far, in our critique of the prevailing ideology of investing, we've examined the standard thinking about diversifi-cation and asset allocation. We've also taken a second look at the commonly accepted reasons for investing in small-company and international stocks. We've found the conventional thinking marred by unexamined assumptions and dubious research. Let's now apply the same kind of analysis to risk. Let's assume that we have assembled a conventionally diversified portfolio with middle-of-the-road allocations spread among all the usual asset classes: U.S. stocks, international stocks, large-company stocks, small-company stocks, and a healthy dose of bonds. Is this a risky portfolio?

It all depends on the time frame. If this were a portfolio designed to build a nest egg for a grandchild's college education 15 years in the future, then, no, it's not very risky at all. There is little question that in 15 years a decent pool of dollars will have accumulated, and there's a high chance that the return would be considerably greater than that of a "risk-free" choice such as a money-market fund. On the other hand, if this sum of money were to be used for a down payment on a house six months from now, that same allocation would have to be termed extremely risky. There's a high probability that overall stock prices will be higher 15 years from now than they are today, but there is no way to predict with any assurance how the markets will act over the next six months. It's entirely possible for every asset in the portfolio to decline in value during that brief period. In other words, the connection between volatility and risk decreases as the time frame increases. In the short term, volatile investments are riskier. In the long term, stable investments are riskier.

This way of viewing risk and volatility doesn't overtax the intellects of ordinary men and women. Yet financial planners and assorted academically based practitioners assume that the investing public cannot possibly grasp this concept and will instead panic whenever the market dips. As a result, planners and money managers try to construct low-volatility portfolios that offer at least some of the benefit of a long-term investment program.

This doesn't make sense. The statistical reality is that only a very small percentage of investors make precipitous moves in times of turmoil. Rather than assume that everyone will panic, I think it's safer to assume that the more investors know about a stock, the more likely they are to be comfortable with it. My strategy for investing in U.S.-based companies with global franchises results in a portfolio of reassuringly familiar names: IBM, Microsoft, Intel, GE, Merck, Citigroup, and the like. When times of crisis occur--as they inevitably will--my investors will rest easier knowing that they own a piece of companies that are a part of their lives. They'll be more confident that short-term fluctuations aren't likely to mean much over the long term. I'd say my approach is more likely to encourage long-term investing than one that equates volatility with risk.

Delusional No More: A Reality-Based Approach to Practical Portfolio Management

"When you have eliminated the impossible, whatever remains, however improbable, must be the truth." --Sherlock Holmes

Applying the great detective's reasoning, we know now that it makes little sense in the long term to own small-company or international funds. They simply don't measure up to the performance of large-company U.S. stocks. We also know that active tactical asset allocation results from confusing risk with volatility; it's antithetical to a long-term investing strategy. So now that we've eliminated small stocks, foreign stocks, and short-term moves in the pursuit of long-term goals, what remains? The option that remains is to buy funds that invest in large-company U.S. stocks and resist the temptation to trade.

My faith in large American stocks is based on my belief that the U.S. version of capitalism is the one best suited for producing superior investments. For one thing, the U.S. markets are the most transparent in the world.

Armed with audited financial statements, regulatory filings, and detailed earnings reports, investors have all the data they need to vote with their dollars, rewarding excellence and punishing mismanagement.

More often than not, the speed with which investors register their votes--that is, allocate their capital--is viewed as a negative. But we must also acknowledge the benefits of our very fluid system. It fosters a process of "creative destruction" that regularly renews and re-energizes the economic landscape, clearing dead wood and inefficient players. It is not only a positive trait; it is absolutely essential to the creation of wealth.

Another advantage the U.S. has over other developed nations is its ability to make maximum use of human capital. If things get tough in the northeastern U.S., it is fairly easy for a worker to relocate to another section of the country where opportunities are greater. Compare this to Europe. If times are tough in Stockholm, it is not very practical to pick up the family and relocate to Barcelona. Asia is even worse. It is simply not an option for the Thai factory worker to move to Japan for a better job.

Likewise, there is no other democratic society where management has as much flexibility to allocate labor resources. To put it bluntly, it's pretty easy to fire workers in the U.S. The short-term pain that downsizing creates is what gets the big headlines. But if employers can't fire, they'll think twice about hiring. Contrast our practices in this area to those of Japan and Europe, where lay-offs are rare and difficult to execute. Is it any surprise that the U.S. has created 20 million new jobs in the past decade, while employment in the rest of the developed world has stagnated?

I'll be the first to say that we don't want to be so wrapped up in the red, white, and blue that we forget that things can change. Not all of the advantages explored here will persist forever. And even with those advantages, the U.S. market is not guaranteed to always perform strongly--in fact, I can guarantee that it won't. What is clear, however, is that we as a nation possess significant competitive advantages that not only help us in good times but also contribute to our ability to right the ship when it strays off course. I can only conclude that, given the weight of these advantages, investment results here in the U.S. will stack up well against any global alternative.

Bigger is Better

"The race is not always to the swift, nor the battle to the strong--but that's the way to bet." --Damon Runyon

As we've already seen, the historical data tend to point to large-company stocks as the better performers over time. But will they continue to outperform in the future? There's no way to answer that with scientific certainty, of course, but it would be irresponsible not to examine the world as it is currently constituted and attempt to formulate a reasonable hypothesis about how things may unfold. From my perspective, it seems prudent to conclude that, in the long run, large-company stocks are likely to deliver superior performance over small-company stocks, with less volatility.

Large companies are better positioned than smaller companies to innovate and exploit new technology. They also have greater material resources--financial and human--giving them a competitive advantage in a global economy. And just as important for our purposes, mutual funds made up of large-company stocks are not subject to the artificial size constraints that handicap small-company funds.

The big winners in the years to come will be the latest benefi-ciaries of a trend that has been in place for 100 years. In the 19th century, the economy was dominated by local and regional companies, or "brands." As new technologies of communication, transportation, manufacturing, and storage were developed, national brands began to develop and eventually dominate. We now find ourselves in the beginning stages of the technology-driven globalization of brands and services. Companies such as Ford, Citigroup, Intel, GE, Coke, Microsoft, Nike, et al. are the brands of choice from Boston to Bangkok.

These companies, and other enterprises that seek to compete on a global basis, face a host of problems that companies undertaking a national expansion never encountered: Language differences. Currency differences. Culture differences. And despite the leveling effects of technology and the Internet, these problems are best managed by the companies with the biggest and best resources--material, human, and financial.

Of course, great size doesn't immunize a company against the multifarious risks of the global marketplace. This was abundantly demonstrated in 1998. Yet even then it was small and midsize companies that suffered the most. These were companies that had "gone global" but were far too dependent on the fortunes of a single country or region. Contrast this with the balance shown by a company such as Intel, which operates on such a large scale that it can spread its business risks over the entire planet. In the first quarter of fiscal year 1999, Intel derived 42 percent of its revenue from North and South America, 28 percent from Europe, 22 percent from the Asia-Pacific region, and 8 percent from Japan. Large enterprises also have the edge in the vital area of research and development. Again, consider Intel. In fiscal 1998, Intel pumped more than $2.5 billion into R&D. Name a small company that could afford such a large budget or that could afford to spread its research efforts over a wide range of promising possibilities.

Even if small companies didn't suffer from these and other relative disadvantages, small-stock mutual funds would still be among the worst long-term holdings an investor could choose. The crucial flaw in small-company investing is that a successful small company doesn't remain small for long. Let's say we manage a small-company fund. Our median market capitalization is around $800 million (the median capitalization of the small-company funds tracked by Morningstar). We own a stock that turns out to be a real winner. It doubles. It now has a market capitalization of $1.6 billion. We're now out of small-company territory and into midsize levels. It rises a further 50 percent, and we're now sitting on a company with a market capitalization of almost $2.5 billion. By any measure, this is no longer a small company. So we sell the stock. Kind of like uprooting your roses and letting your weeds continue to grow. Contrast this dilemma with the freedom of a large-company fund. It can let its winners ride in-definitely. They never become too large.

It seems evident, then, that our interests as long-term investors are served best by funds that invest in large companies. But we still have to make one more important decision: growth or value? There are two broad categories of funds that invest in large-company stocks, growth funds and value funds. Managers who are growth investors usually look to earnings as their primary focus. The philosophy is that stock prices ultimately follow earnings. As earnings grow, so, too, should the price of the stock. The typical growth-fund manager looks for companies experiencing or about to experience rapid and sustained increases in revenue and profits. The manager expects those increases to translate into a soaring stock price.

The typical value manager tends to be more of a bargain hunter, seeking companies that are out of favor with Wall Street and whose stock prices are thus temporarily depressed. Companies they like will tend to be "cheap" as measured by some standard valuation criterion such as price-to-earnings ratio, book value, or some other historic norm.

It is an ongoing dispute in the investment world as to which style of stock picking is superior. There have been periods when growth was king and times when value was clearly the winner. But as we've already seen, we should be wary of setting too much store by historic returns. There is a wild card in the deck, and you don't want to play your hand until you've taken it into account. The wild card is technology. I am of the camp that believes technology is transforming our lives and will continue to do so. An ever larger percentage of the U.S. economy's growth each year is directly attributable to technology. One of the few sure bets for the next 20 years is that the largest and most successful companies will be those that create and take advantage of new technologies.

To be sure, this unfolding process of innovation and transformation carries significant risks. We can't deny that an awful lot of high-priced technology stocks are destined to crash and burn. But the concerns of the tech-nervous aren't really anything new or particularly perceptive. Over the past 20 years, plenty of high-fliers have fallen to earth. Yet when all was said and done, with all the ups and downs, technology stocks have returned more than any other sector. So, yes, there is great short-term uncertainty in technology investing. But those who are willing and able to accept this short-term uncertainty receive in exchange greater long-term certainty of excellence.

The problem for the value camp is that technology companies are by their nature dynamic, rapid growers. Their stocks almost invariably are tagged as growth stocks. When we see how value investors view the world, and how they judge the worth of stocks, it's no wonder that few technology companies show up in their portfolios. According to Morningstar, the average large-company value fund has an 11 percent weighting in technology, about half of the weighting in the Standard & Poor's 500. I can't help thinking that it's going to be pretty hard to

capture the dynamic of the 21st-century economy with such marginal participation in its most dynamic sectors.

With that in mind, an equal weighting between growth and value is probably not the most productive strategy. Funds with a growth orientation should dominate your portfolio. And those growth funds should have a larger exposure to technology than to the market as a whole. This could increase your portfolio's short-term volatility, but we have already discarded the notion that volatility equals risk. In reality, positioning your portfolio to more accurately reflect the economy of the future is less risky than clinging to notions that may not be relevant to the world ahead.

Theory into Practice

"Now is always the most difficult time to invest." --Anonymous

It's time for me to take the investing lessons i've learned and turn them into a working portfolio. This is actually a fairly simple process. I divide every portfolio into two parts. One is the equity allocation, the portion that will provide the signifi-cant growth potential and also expose it to short-term volatility. The other part is the bond or money-market allocation. This portion won't contribute much growth but will act as a short-term stabilizer. Our choices in the fixed-income sphere will be limited, since we are relying on that portion of the portfolio for stability. Conventional corporate and Ginnie Mae bond funds are too volatile for our purposes. Only money funds and bond funds that hold high-quality bonds with very short maturities are suitable. In most cases, with proper selection, they can offer a somewhat higher return than a money fund with minimal additional volatility. Their stability permits us to allocate slightly more to equities than would otherwise be prudent, resulting in higher returns over the long haul.

Wait. I'm advocating diversifying among asset classes to reduce volatility. Doesn't that sound a bit like the efficient frontier? Yes, but there's a crucial difference. The major flaw in the efficient-frontier model is its assumption that it's possible to determine the future correlations between various equity asset classes. I maintain that is simply impossible.

It is possible, though, to know how the fixed-income component of the portfolios I've designed will react to any stock-market situation. Its reaction is always the same. Every day of every year, the money-market or bond-fund portion of the portfolios will earn a small but steady rate of interest, with the principal rock steady, or nearly so. The effect of this allocation on an overall portfolio is equally predictable. When the stock market is strong, the fixed-income component will be a drag on performance. When the market is plummeting, it will perform as a stabilizer. No surprises.

As more bond or money-market funds are layered in, short-term volatility is reduced, as is long-term return potential. So how these two asset classes should be mixed depends on the individual investor's desired return and tolerance for volatility. People whose goals are far in the future can afford to be the sort of investors whose time horizon is, as Warren Buffett once said, "forever." Others will have dollars that they'll need in two to three years that should not be totally exposed to market volatility. Others may have a long time horizon but may desire stability more than growth. In these and other circumstances, it is appropriate to diversify away from large-company funds.

In any case, the cardinal rule remains the same: Never use one equity asset class to hedge against another equity asset class. Only bonds and cash should be used to reduce the volatility inherent in large-company U.S. stock funds.

On this page, I list three sample fund portfolios. Think of them as the at-home versions of the Markman Multifund portfolios I manage for my shareholders. One is designed for aggressive investors, one is for conservative investors, and one is for middle-of-the-road types. None is right for everyone, but all three offer investors the opportunity for growth with varying degrees of stability, unhampered by the investing myths and superstitions that I hope I've exposed for the bull--, well, the nonsense they are.

NO-BULL PORTFOLIOS			
FUNDS	CONSERVATIVE	MODERATE	AGGRESSIVE
MARSICO FOCUS	10%	5%	20%
WHITE OAK GR. STK.	10	5	20
RYDEX OTC	10	15	20
FIRSTHAND E-COMMERCE	10	15	20
FIRSTHAND COMMUNICATIONS	10	15	20
PIMCO SHORT-TERM	20	10	0
STRONG ADVANTAGE	20	10	0
MONEY-MARKET FUND	10	5	0

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