



The Enemy Within

UNDERVALUED SECTORS (CONSIDER!)

- LARGE CAP VALUE
- DIVIDEND STOCKS
- CONSUMER DEFENSE

OVERVALUED SECTORS (AVOID!)

- HOME BUILDERS
- CALIFORNIA MUNICIPAL BONDS
- AIRLINES

Cognitive bias is a human phenomenon that is an acknowledged branch of psychology. Cognitive bias is the tendency of intelligent, well-informed people to consistently do the wrong thing. It is a kind of blind-spot in our brains — the result of short-cuts or habits within our thinking process — that can lead us to make less productive choices.

The story of Henny Penny is an example of cognitive bias. “One day Henny-Penny was picking up corn in the cornyard when— whack!—something hit her upon the head. ‘Goodness gracious me!’ said Henny-penny; ‘the sky’s a-going to fall; I must go and tell the king.’” Henny had a blind spot in her thinking believing that because something hit her then everything would fall. Investors often make investment decisions the same way. The best way to convince someone to buy your favorite stock is to tell them a story showing a path to future profits. People readily understand stories

and the path that you outline from the company’s current activities to its future profits will seem far more likely since it is presented in story form. The listeners will naturally reject the myriad of alternative outcomes for the stock as far less likely, since they cannot see a path to these alternatives. This is the reason that “story stocks” are so important.

Using the same thought path investors repeat their same mistakes time and again. Forbes magazine in a December 22, 2003 article, “Our Own Worst Enemy”, stated that mutual fund investors have let one trillion dollars slip through their collective fingers over the last decade. What has caused this? As Forbes and others have pointed out, investors, like Generals, are always fighting the last war, because of cognitive bias. Warren Buffett has weighed in on this topic stating that most investors look through the rear view mirror instead of the windshield, continually seeking out yesterday’s winners and projecting out a few years worth of strong performance infinitely into the future, just as Henny did.

The Boston-based market research firm Dalbar has done several very comprehensive studies of the results of mutual fund investors’ behavior over the years. Their 2004 report, “Quantitative Analysis of Investor Behavior”, came to the stunning conclusion that the average mutual fund investor has realized a measly 3.51% annual total return from equity mutual funds versus 12.98% for the S & P 500 over the past 20 years. Not only did they tremendously under-perform the overall stock market, the typical mutual fund participant barely kept pace with inflation over the same time period.

The Enemy Within (cont.)

Dalbar further segmented the universe of mutual fund investors between those who were consistent, or systematic, participants and those who tried to time the market. Unsurprisingly, those who attempted to outwit the market only managed to victimize themselves as they actually incurred **negative** returns of 3.29% per annum.

Wall Street is partially to blame, always creating the “story” when selling mutual funds. The mutual fund industry has shown a rather cynical tendency to follow the old Wall Street adage: “when the ducks are quacking, feed them.” And feed them they have, as the fund managers have churned out sector funds to exploit whatever the current fad might be, thus showing an acute awareness that money does chase performance.

This is why the investment roadmap is so important. To be successful over the long-term, portfolios must be constructed to avoid temporary investment fads while buying low and selling high. That seems like a simple objective but, as Dalbar proved in their study, most investors don't do it. We at Centurion feel that the asset allocation models designed for our clients help us and our clients avoid the bias trap.

Why Managers Outperform Equity Indexes

When we meet with potential clients, we are often asked why they should work with an investment manager rather than investing their assets in a “cheaper” equity index that mirrors the performance of the greater market (eg. The S&P 500). Besides, the market always goes up over the long haul, right? Well...Numbers speak a lot louder than words, particularly for those investors who are so focused on the costs in managing their portfolio.

The chart on the following page compares the investment performance of U.S. diversified stock funds in various time horizons over the past 5 years. The funds themselves are broken out between small, mid, large and multi cap companies focused on growth, value and income respectively. Between them, these funds make up the majority of the overall equity market...and a pretty good proxy for the S&P 500. Now, given that the S&P 500 is made up of the majority of these stocks, the index should perform at the average of the aggregate performance of these diversified stock funds right? Wrong. The average annual performance of the diversified funds over the past 5 years was just below breakeven at -0.11%. The S&P 500, in contrast, was down -1.53% annually - over 140 basis points worse per year!

Why Managers Outperform Equity Indexes (cont.)

U.S. Diversified Stock Funds

Total % returns through Feb 28, 2005 - ranked by 5 year average annual return

<u>Fund Category</u>	<u>1 month</u>	<u>3 mos.</u>	<u>YTD</u>	<u>1 year</u>	<u>3-year*</u>	<u>5-year*</u>
Small-Cap Value	2.78	2.66	-0.27	14.89	15.03	16.86
Mid-Cap Value	3.25	4.16	0.61	13.98	12.82	14.45
Small-Cap Core	2.36	2.32	-0.81	11.68	12.24	8.01
Multi-Cap Value	2.81	4.05	0.65	10.58	7.79	7.69
Equity Income	3.06	4.28	1.20	10.59	6.77	6.47
Large-Cap Value	2.84	3.94	0.88	8.82	5.83	5.53
Mid-Cap Core	2.71	3.58	0.00	10.74	9.95	4.75
Multi-Cap Core	2.04	2.93	-0.48	6.70	5.39	0.23
S&P 500	2.06	2.86	-0.48	6.34	4.01	-1.53
Large-Cap Core	1.79	2.74	-0.60	4.32	2.51	-2.57
Small-Cap Growth	1.72	1.78	-2.19	4.28	6.75	-5.50
Mid-Cap Growth	1.86	3.28	-0.97	7.24	5.89	-7.12
Large-Cap Growth	0.51	0.79	-2.87	1.72	0.71	-9.00
Multi-Cap Growth	1.26	1.17	-2.46	4.69	4.23	-9.65
U.S. Diversified Funds	2.01	2.68	-0.71	7.19	6.07	-0.11

Source: Lipper Inc.

* average annual return

The reason for this discrepancy has to do with the weighting of companies within an index. Companies in the S&P 500 are weighted on a market capitalization basis (stock price x shares outstanding). As such, companies that have a higher market capitalization (ie. large cap) have a greater weighting in the performance of the index itself. Naturally, with large cap funds underperforming over the past 5 years, this will cause a negative drag on the index's performance. However, this doesn't tell the whole story.

As the market caps of the companies within the index change over time, the S&P 500 itself begins to mirror these underlying changes. For example, during the late 1990's, technology stocks were the darlings of the market and hence became an increasingly large component of the broad market, such that the S&P 500 was VERY heavily weighted with technology companies. As a result, investors buying S&P 500 index funds with the intention of broadening and diversifying their equity exposure were, in fact, doing very little of either and, to a great extent, were buying into a technology driven index that ultimately crashed at the turn of the new century.

Why Managers Outperform Equity Indexes (cont.)

Further accentuating the problems with buying a 'broad' index fund is that the market cap weighting within the index also means that you, as an investor, are buying exposure to the largest companies within the index. In effect, that means you are buying companies as they become larger in value. In other words, by default, you are buying companies at their high (buy high) and getting more exposure as they get higher in value (buying higher) with each investment. By the very nature of its market cap weighting, the index fund forces investors to buy increasing exposure in larger companies at an increasingly higher price. Furthermore, when these 'hot' sectors ultimately fall in value, the index (and the investor) are hit disproportionately hard as the larger companies within the index have the furthest to fall in the sector that's hit hardest.

Currently, the S&P 500 is overweighted in the financial services sector with 20.7% comprising the overall index, followed by healthcare at 12.4% and industrial metals at 12.3%. Wanna bet how many investors in the S&P 500 index are really aware how much their performance can decline in the event of a downturn in the financial sector, not to mention healthcare or industrial metals? Me neither. Plus, they're buying more and more exposure at higher prices with each contribution that they make.

On the flip side, in rising markets, the S&P 500 index will outperform the individual sectors for exactly the same reasons (sectors that are performing well will make up a higher percentage of the index.) However, there's an old adage "it's not what you make, it's what you keep" and the gains that can arise from overweight industry exposures are the same ones that can disappear when the tide turns the wrong way. Avoiding situations like these is one of the most important benefits that come from working with a good investment manager.

Centurion's role is to produce long term returns and work dilligently to ensure that our investors retain their investment assets. Using individual securities and focusing on market sectors rather than the market as a whole has allowed us to do so successfully for a number of years. The oldest mantra is the investment business "buy low, sell high" still holds true to this day. We promise to continue to adhere to these principles as we work dilligently to do our best for you and all of our clients.



Centurion Counsel Wishes You Continued Prosperity in 2005!