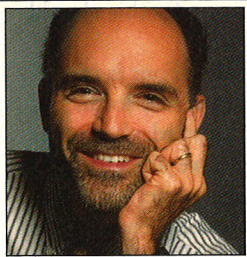


The Fundamentalist



by Jason Zweig

False Profits

You now have all the tools you need to pick your own pocket.

Back in the bad old days, Wall Street swarmed with knaves and shysters who hawked moneymaking magic: Buy our tax shelters! Invest in a low-return, high-cost mutual fund! Let me trade soybean futures for you! ♦ These days, the get-rich-quick gang talks about “empowerment” and “taking charge of your own life.” Too often, this ends up meaning that you can pick your own pocket, instead of paying someone else to do it for you. Although there are people who consider this progress, I am not one of them.

Everywhere you turn, someone is selling investment hogwash: seductive-sounding ideas that will supposedly enable you to beat the market and buy a tropical island with the proceeds. Using your own wits and the new weapons of online information, say these folks, you can make Wall Street’s pros look like birdbrains—but you’ve got to hurry.

Fidelity.com, for instance, tells you, “Every second counts.” *Business Week* lionizes a retiree who used the Internet to trade in and out of his mutual funds 22 times in the first four months of 1999. The Motley Fool says it has a system enabling you to “crush” the market in just 15 minutes a year. *Time* magazine columnist Jim Cramer says “there’s good reason” for you to become a day-trader. Robert Markman, a prominent financial planner, declares in *Worth* magazine that diversification is a stupid idea.

What it means to be right

In the past year or so, many investors’ minds have been hijacked by these false beliefs; as Third Avenue Value Fund’s manager Martin Whitman likes to say, “The inmates have taken over the asylum.”

More than ever, people think the test of an investment’s validity is whether it “worked.” If they beat Standard & Poor’s 500-stock index over any period, no matter how dumb or dangerous their tactics, people boast they were

“right.” But investing successfully over the course of a lifetime has nothing to do with being right in the short term. To reach your long-term financial goals, you must be sustainably and reliably right. While the techniques that are so trendy now—day trading, ignoring diversification, flipping funds, following “systems”—may seem right on a given day, they slash your odds of being right in the long run.

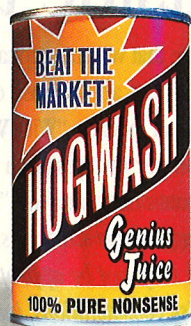
Imagine that two places are 130 miles apart. If I observe the 65-mph speed limit, I’ll drive this distance in two hours. But if I go 130 mph, I can get there in just one hour. If I try this and survive, am I “right”? Should you be tempted to try it too because it “worked”? The flashy new ideas for beating the market are much the same: In short streaks, if you’re lucky, they will work. Over time, they will get you killed financially.

To see whether someone is truly right and an investing idea really works, you have to test it as a scientist would. First you need a hypothesis, a commonsense explanation of why the technique should work. Then you need a large amount of accurate data testing the idea both before and after it was discovered. Finally you need to ask: Could this just be dumb luck?

The “Very Stupid” portfolio

Let’s test a trendy “strategy” in detail—and see how to stay out of trouble by analyzing any investing idea skeptically.

The Motley Fool website and books have popularized the idea that you can beat the mar-



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ket with a basket of four high-yielding stocks in the Dow Jones industrial average. At first, the "Foolish Four" seems sensible: Stocks with big dividend yields are cheap, so they should do well in the future.

But the folks at the Motley Fool can't leave well enough alone. They claim you'd have "trashed the market averages over the last 25 years" by picking the five lowest-priced, highest-yielding Dow stocks. Then you'd discard the one with the lowest price and put 40% of your money in the second lowest-priced stock and 20% each in the third, fourth and fifth lowest.

(This way you'd have beaten the S&P 500 by 10.1 points a year from 1973 to 1997.) Or you could pick the five Dow stocks with the highest ratio of yield to the square root of stock price, then drop the one with the highest ratio and buy the second through fifth highest. (This

would have beaten the S&P by 11.5 points annually for 25 years.)

No, I'm not making this up—and yes, you're right to be confused. As financial planner Bill Bernstein has pointed out, there's no way these cockamamie contortions add up to a rational hypothesis. Why on earth

Why would the square root of a stock's price affect its future return?

should the square root of a stock's current price (divided into its yield or anything else) affect its future return? Why would anyone in his right mind drop the stock that scores highest for a desirable quality but keep those that score second through fifth? (The Motley Fool

folks assert that the single lowest-priced stock can be "dangerous," since it's often financially troubled; but they don't explain why the stocks whose prices are right behind it should be any safer. And they say a stock's volatility is generally affected by its price, but

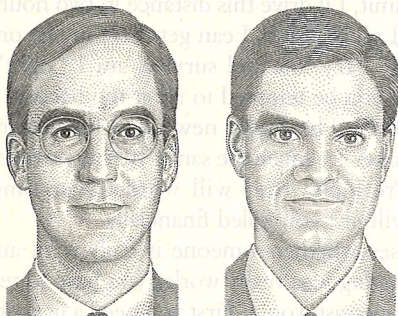
they offer no reason why this should be true for the Dow.)

In short, the Foolish Four is investment hogwash in its purest form. Just as we can "predict" yesterday's weather with 100% accuracy, we already know exactly which stocks outperformed in the past. If we look long enough, we can find *some* attribute they share—but it's far more likely to be a complete coincidence than an actual cause of their high returns.

To show how easy it is to concoct something that works like the Foolish Four portfolio, I tried it myself. With the help of Kevin Johnson, a money manager at Aronson & Partners in Philadelphia, I studied up to 10,500 stocks a year back to 1980.

Here's what we found: Beating the market over the past two decades was a breeze. All you had to do was buy stocks whose names are spelled without repeating any letters. To heck with that Motley Fool complexity: Texaco, good (no repeated letters); Exxon, bad

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Harold E. Sharon and J. H. Cullum Clark
Co-Portfolio Managers
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This fund may invest in a company that has received venture-capital financing during the early stages of the company's existence or as part of a restructuring or recapitalization. The investment of venture-capital financing, or distribution of such company's securities to venture-capital investors, or initial public offering (IPO), whichever is later, will have been made within 10 years prior to the fund's purchase of the company's securities.

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Lipper Global Funds Rankings

1 Year
5/31/98-5/31/99 **12 out of 237**

Since Inception
9/30/96-5/31/99 **25 out of 160**

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(two X's). I call this the "Very Stupid" portfolio—since that title, like our stocks' names, repeats no letters.

This year, Very Stupid is chock-full of stocks like Numex Corp. (up 316%), Grey Wolf (up 208%) and Ultrafem Inc. (up 100%); last year, Very Stupid would have held Jam Inc. (up 4,900%), IFX Corp. (up 409%) and Gap (up 138%). During our nearly 20-year period, a Very Stupid investor would have beaten the market by 1.3 percentage points a year.

But I didn't want just to beat the market; I wanted to pound it to a bloody pulp. So we tinkered some more and cooked up the "Extra Dumb" portfolio, which holds only the bottom 25% (by market value) of stocks without repeat letters in their names. That portfolio whopped the market by six points a year for two decades.

Am I kidding? Yes and no. Our data

do prove what we say; a Very Stupid or Extra Dumb investor really would have beaten the market for nearly 20 years. But that doesn't mean that we're right, or that this portfolio will work in the future. If Kevin and I can't explain why it makes sense—and believe me, we can't—our "strategy" can only be dumb luck.

**Our data prove
that a Very
Stupid investor
would beat
the market.**

What really works

There's a lesson in all this nonsense: Unless someone has a sensible explanation and good data to document a strategy's returns—both before and after it was created—you're dealing with investment hogwash.

When 90% of professional investors, with their M.B.A.s and powerful computers and multimillion-dollar research budgets, can't beat the market, why should you believe anyone who says *you* can do it by day trading? (After all, the new information that comes to you

over the Internet comes to the pros too.)

When a financial planner says that diversification doesn't work and you should put all your money in big U.S. growth stocks, ask why you would ever want to bet everything you've got on what's been hot in the recent past—instead of holding a wider, safer variety of assets that should go up in the future.

When someone trades his mutual funds 22 times in four months, ask whether there's a shred of evidence that he can earn more money that way than he could merely by sitting still.

If the inmates take over the asylum, here's a simple solution: Steer clear, stay sane and stick to what's always worked in the fullness of time—a diversified portfolio of U.S. and foreign stock and bond funds that you hold for years on end. In the long run, *that's* the best kind of empowerment for most investors. **ES**

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Growth & Income Fund



Brian S. Posner, Portfolio Manager
Warburg Pincus Growth & Income Fund



The Money 100 appeared in the June 1999 issue of Money Magazine. Approximately 1,600 funds were analyzed by Morningstar in rolling three-year periods over the past five years; and for each of the 25 periods, beginning with February 1994 to February 1997, each fund was given a percentile score in its category. Percentiles were averaged to measure each fund's overall consistency. To select the 100 Best, Money Magazine staff then analyzed the funds based on percentiles, performance, expenses and other factors, including interviews with financial planners, fund experts and fund managers.

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