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LOST SHEEP

By David Andrew

Mutual funds are attractive in some situations. They allow smaller portfolios access to diversification and professional management. Funds offer liquidity and ease of purchase. We have successfully used mutual funds when we wanted exposure to a specific market sector. Mutual funds should be used only where appropriate. They should be analyzed in careful detail and continuously monitored.

The mutual fund industry has changed dramatically in recent years. An old children's nursery rhyme illustrates the misguided direction of some mutual funds today.

*Little Bo-peep has lost her sheep,
And doesn't know where to find them;
Leave them alone, and they'll come home,
Bringing their tails behind them.*

Like the sheep of Little Bo-peep, many feel the mutual fund industry has lost its way. One of the more vocal industry critics has been John C. Bogle, founder and former chief executive of the Vanguard Group of mutual funds. As an eminent industry insider, Mr. Bogle feels that the focus of the mutual fund industry has dramatically changed over the last decade.

Many mutual funds have gradually changed their emphasis from what *used* to be an investment management business, to what is *now* a marketing business. Instead of treating funds as investment trusts designed to serve their owner-beneficiaries, many funds are now managed as consumer products, designed to attract the largest possible assets. Mr. Bogle feels this approach has ill-served the interests of fund shareholders. While many factors have contributed to cause this misdirection, the primary reasons are:

- a diminishing focus on stewardship
- managers chasing short-term performance objectives
- shrinking investment horizons
- soaring management and trading costs

One manifestation of this industry malaise has been the dramatic number of fund failures. From 1950 through 1965, funds were long-term investments; fund managers were long-term investors and fund shareholders held their shares for more than a decade. Costs were not excessive and performance measured up to the reasonable expectations of investors.

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By and large, none of this is true today. Funds, once investments for a lifetime, now come and go at a remarkable rate. Some vanish when they fail to achieve their investment objectives; they are liquidated or merged into other funds. Others, created to reflect the investment fashions of the moment, disappear when the fad passes.

During the 1990s, 55% of all equity funds failed, almost four times the 14% failure rate of the 1960s. Should the recent failure rate hold, 2,500 of today's 4,500 equity funds won't be around in 2010. Their shareholders will be victims of uncontrollable changes and will likely be subject to either paying additional taxes when they liquidate their shares or forced to transfer to a new fund.

Another glaring change has been the shrinking investment horizon of investment managers. Many fund managers, once long-term investors, have now become short-term players. Acting like speculators, fund managers now hold stocks for an average of only 406 days. This contracted holding period has little to do with traditional *investing*. Fund turnover, averaging about 17% during the 1950s and 1960s rose to 90% last year. While the hyperactive trading atmosphere of the day is partly responsible, it seems there are far too many "gunslinger" portfolio managers. The industry's dominant force has changed from consensus to impulse.

The focus on short-term performance objectives has also caused portfolio managers to come and go at a rapid rate. The average manager lasts just six years, and then a new broom sweeps the portfolio clean. The excessive turnover in both portfolios and managers hurts the returns of fund investors. The heavy trading costs involved in high-turnover funds mostly benefit those who execute the transactions. The biggest beneficiary of high turnover is the federal government, which has reaped billions of dollars from taxes on short and long-term capital gains.

Some investors don't understand that significant taxable gains can be realized without selling a single fund share. Also, investors who buy funds

today are possibly inheriting large unrealized gains from lower-cost purchases made in years past. Fund shareholders are unable to control the timing and amount of capital gains. The unexpected realization of capital gains accounted for a major portion of the \$30 billion of federal taxes paid by fund investors in 1999.

The contagious short-term virus has now spread to fund shareholders. Share redemptions, which ran at about 8% of fund assets during the 1960s and 15% during the 1970s, leaped to 30% during the 1990s, and are running at an astonishing 47% rate in 2000. This dramatic increase suggests that fund shares — once held by long-term investors for an average of 12.5 years — are today held for an average of just over two years. Actual redemption rates are really much larger since the data excludes redemption proceeds that are reinvested in funds of the same fund family.

All of these measures of mutual-fund investment activity—funds that come and go, portfolio holdings that come and go, portfolio managers who come and go, and fund shareholders who come and go — frustrate the achievement of long-term investment objectives. Mr. Bogle believes the mutual fund industry is developing into a form of *casino capitalism*.

The root cause of these failings is the industry's inability to focus on the primacy of the fund shareholder. It's called *stewardship*. The Investment Company Act of 1940 warns against managing funds in the interest of investment advisors rather than the interest of shareholders. Unfortunately that warning is not adequately heeded today.

While the mutual fund industry certainly has many problems of its own making, there are still good funds available. Not all funds are guilty of these transgressions. Certain mutual funds can deserve a place in one's portfolio. But, considering the excess baggage that most funds bring on the path to investment success, a diversified portfolio of individual securities can provide better performance, more control and fewer surprises.



End of the Long-Bond's Reign

By Peter Boyle

For more than 20 years it has been relatively easy to take the pulse of the U.S. bond market—just glance at the 30-year Treasury bond. However, due in large part to the government's recent aggressive effort to shrink its long-term debt, the long-bond's reign as the benchmark for the \$14.7 trillion U.S. bond market is ending.

Since the only 30-year instrument most of us consider is our home mortgage, this lessening role of the long bond has gone largely unnoticed. That aside, recent events in the Treasury market have implications beyond choosing a benchmark to observe. A bond-market benchmark provides a valuable gauge for the performance of bonds, and it also reflects expectations about inflation and the future interest-rate policy of the Federal Reserve. Investors also often compare their potential investments to Treasuries as a hypothetical risk-free rate.

HISTORY

As recently as the early 1970s, prior to regular 30-year Treasury auctions, investors used a group of top-notch corporate bonds and various Treasuries as their benchmark. In 1977, when government debt was exploding, the Treasury began regular auctions of 30-year bonds. Because these bonds carried higher coupon rates and were more sensitive to changes in interest rates than other Treasuries, they quickly became the new benchmark.

The long bond received its greatest attention in the mid 1980s when oil prices collapsed and bond prices shot up 50% in a single year. Issuance of these bonds reached its peak in 1991 when the Treasury issued \$47 billion in 30-year bonds. By comparison, the Treasury auctioned a mere \$20 billion in 30-year bonds in 1999 and is expected to issue an estimated \$15 billion this year (see chart).

WHAT CHANGED?

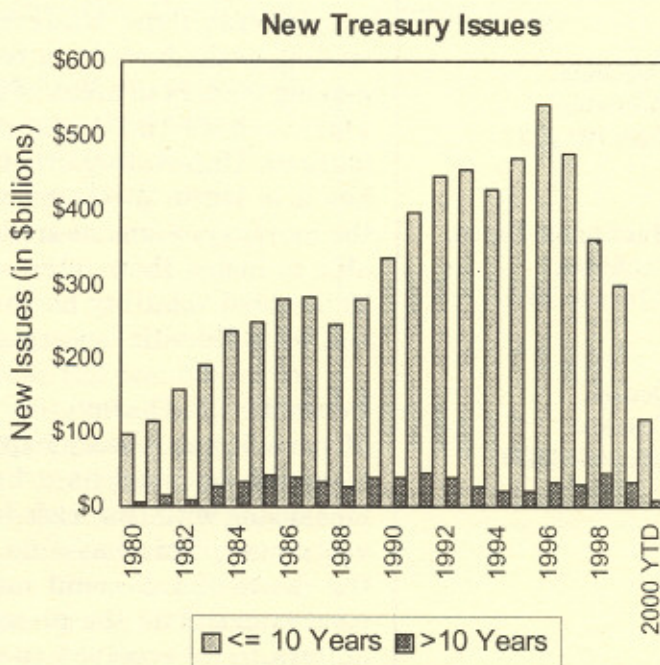
Eight consecutive years of economic prosperity and positive stock market performance, with little or no tax relief, have created surging tax revenues, helping to create two successive years of budget surpluses—a feat not witnessed since the 1950s. Suddenly flush with revenues and unable to agree on how to spend them, the government's appetite for new debt has been diminished. In response, the government has decreased the size and frequency of certain bond auctions and eliminated others entirely.

IMPACTS

The Treasury's decision to reduce the issuance of new debt has dramatically altered the supply-demand relationship in the bond market. This has reduced liquidity and market efficiency, adding a new level of volatility to the U.S. Treasury market.

Federally-sponsored agencies have attempted to fill the void in long-term bond offerings. The Fed-

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The amount of new long-term debt issued by the U.S. Treasury has been steadily declining.

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eral Home Loan Bank, Federal Farm Credit Bank, Fannie Mae and Freddie Mac have reworked their offerings to both increase regularity and offering size. They have also recently begun to regularly issue long maturities. For the foreseeable future though, their volume is still dwarfed by the Treasury market.

In light of these events, several institutions have abandoned the 30-year bond in favor of the 10-year as a benchmark for pricing their longer-term offerings. In May, the *Wall Street Journal* replaced the 30-year bond in its market diary column with the 10-year—further evidence that the market has moved away from its prior benchmark. The U.S. appears to be moving more in line with Japan, Germany and England who all use their 10-year bond as the bond market standard.

As trading has declined in the Treasury arena, bond traders and bond trading desks have been reconfigured, moving traders to areas of greater volume such as the Agency and Euro markets. Uncertainty in benchmarking has also led to increased volatility in the mortgage arena as traders are less able to hedge their interest rate risk. This added volatility has had some effect on residential mortgage rates.

INVESTMENT VALUATION

Modern finance theory requires a risk-free rate be used as a baseline for measuring differing risk levels of investments. This baseline influences the choice of a discount rate, which is used to calculate the present value of dollars to be received in the future. Added uncertainty concerning what discount rate to use for investment

valuation only serves to add to the risk and therefore diminishes investment value.

FUTURE

What does the future hold? Does this mark the end of the 30-year bond? What moved us to this point was a remarkable confluence of events: tremendous growth in the U.S. economy, restrained government spending in proportion to revenues, and little tax relief. None of these factors will necessarily continue indefinitely. As we have witnessed in the past, estimates of U.S. surpluses are constantly changing and are impossible to predict with any accuracy.

Further, both political parties are battling over a combination of tax cuts and spending increases that are sure to whittle away any future surpluses. Federal Reserve Chairman Alan Greenspan is constantly cautioning us on the dangers of unrestrained growth, and may not let the current expansion continue unchecked. Further, recall that the mild recession in the early 1990s and the slow growth that followed doubled the national debt in only three years.

The result from a diminished Treasury supply should be the broadening of our notion of a single bond market benchmark. LIBOR-based (London Interbank Borrowing Rate), Eurodollar, and an expanded Federal Agency market have and will continue to witness increased attention.

For the time being though, we have entered the reign of the 10-year bond. No other bond market in the world offers the size, liquidity and low risk of the U.S. Treasury market.

