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Lancer Offshore, Inc.

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Indexation: a legitimized financial pyramid that caused the valuation bubble. Its about to burst.

Summary: *Embraced as lower cost, tax efficient, less than average risk, and a likely bet on superior investment performance, the S&P 500 indexation strategy and its "enhanced" offspring, have come to dominate the domestic investment scene. As the strategy's popularity has surged, the massive capital inflows into its underlying stocks has resulted in the valuations of the top tier components of the S&P 500 being driven well past their reasonable economic values, creating perilous pricing excesses. As indexation outperforms the alternatives, it becomes an ever more powerful magnet for incremental capital, which by mandate has to keep flowing into the same stocks (at the expense of the rest of the market), further reinforcing their superior performance. Thus, what was once intended as a strategy to link investment fortunes to the market via an actual index, has now inverted, with equity capital now trying to link itself to the index. The investment community's relative complacency vis-à-vis the risk in the index persists on the theory that owing to the general demographic dynamics, more money will continue to follow, and thus support the pricing, regardless of the underlying economic values. In our opinion, the "greater fool" money flow dynamics and the "relative" performance investment focus by most institutional investors that propelled the indexers' momentum on the upside, will shortly (may have already) reverse 180 degrees, and commence an urgent capital flight, battering the index, and causing it to further under-perform the general market (which will retreat less dramatically). The catalyst for this reversal will be the top tier companies' significant earnings shortfall relative to Wall Street's expectations over the next three to nine months. As the top S&P 500 components begin their retreat (in some cases we expect pullbacks of well over 50%!), it will be apparent to the "relative" performance investors that the best strategy for outperforming the index will be to minimize portfolios' exposure to its top tier components.*

It is a rare indulgence for us to address only one issue in a correspondence (second part of which will follow shortly), but we believe that the S&P 500 indexation phenomenon (and its derivative forms) is indeed a worthy subject, owing to both its pervasive popularity, and its influence on stock market trends, as well as the less appreciated risks inherent in the strategy. What prompts this note at the present time is our conviction that the S&P 500 indexation strategy is about to unravel, thus the timeliness and the impending bruising impact on the entire stock market (by extension consumer confidence and the economy) needs to be considered forthwith. We fear that as never before, the destiny of the US. market is buttressed by the shoulders of a few dozen valuation inflated stocks, which are about to experience fairly rapid capital outflows, with ominous implications for the very indexes that they are guilty of over-inflating.

The seduction of indexation

The theoretical case for indexation is in fact quite compelling and eagerly advocated by most academics and at least half a dozen Nobel Price winners. Starting with a premise of absolute market efficiencies and thus the implied futility of trying to outperform the averages by selective stock picking, the indexation proponents point out historical superior returns vs. the "active" managers, lower operating costs, greater tax efficiency, as well as implied lower risks, presumably owing to holdings' diversity. As this convincing case is woven, what indeed is wrong with an investor desiring to own a representative piece of a given market segment, without the risks of the already higher cost burdened "active" managers potentially missing the boat by buying "wrong" stocks? Frankly, nothing. Indexation as it was intended is in fact a reasonable "passive" investment strategy, well deserving of representation among the product cornucopias offered by the financial community.

Reality of indexation: the index becomes the market

The problem is not with indexation as a concept but rather the alarming reality that the S&P 500 index specifically has evolved into a highly risky momentum money machine, sustained only by incremental inflow of funds. As a consequence, it has decoupled from both reasonable economic values and the rest of the market (over 9000 publicly traded stocks). It strikes us as odd that this demonstrable metamorphosis of the S&P 500 index from what was intended as a relatively conservative investment strategy (and still perceived as such by many) into a legitimized pyramid scheme, with all the underlying principles of "greater fool" dynamics in place, has not received more critical scrutiny by either the Federal Reserve, the market regulators, the Wall Street community, or the financial media. However, those bodies have rarely been guilty of foresight, so we suspect that in line with historical patterns, their scrutiny will be again retrospective in nature, only after the disintegration of the S&P 500 indexation takes place.

Not unlike the 1980's financial and real-estate bubble in Japan, while it lasted, few seemed concerned about the underlying valuation excesses, believing that capital flow dynamics would remain one-directional and would certainly in turn support prices regardless of merit. Only in hindsight do those expectations seem naïve.

In a nutshell, the S&P 500 (particularly its "enhanced" cousins) indexation explosion and the valuation excesses it has spawned among the very highest tier of stocks (in terms of market cap) is a stepchild of a fundamental shift in institutional investors performance objectives, one from absolute returns to relative benchmark gauging. It is now quite acceptable for portfolio managers to lose money, as long as the value erosion is less than that of the benchmark. With the benchmark committees superceding investment committees, the portfolio compositions no longer depart significantly from the major S&P 500 components, as that would entail considerable risk of relative underperformance. Playing on enhanced variations of the index has become a more certain approach to outperforming the same, and thus continuing to attract more funds, that will then be plowed back into the underlying stocks, further perpetuating the pyramid.

As the S&P 500 became the benchmark of choice, the index has acquired an unintended super-significance that eclipses the market itself, and thus minimizes the importance of the underlying economic values. Thus the proverbial "tail waging the dog" paradox. While indexation conceptually suggests a representative exposure to the market generally, during the past several years, the market (as defined by new, or transferable investable equity), has now de facto become the S&P 500 index, because that is the targeted performance bogey. Thus the prevailing rational for investing in the index components is primarily a function of benchmarking strategies, with any economic or valuation considerations of the given holdings being very secondary. Recognizing the indexation's steamroller effect, the normally healthy and desirable stabilizing speculation that would keep valuation near reasonable levels is curtailed, diminishing the market's valuation efficiency.

Masquerading money managers

We are now in an environment in which the would be "active" money managers who are entrusted to pick stocks based presumably on fundamentals (charging fees that are three to five times those of a plain-vanilla index), are essentially enhance-indexing their portfolios, which then further exacerbates the valuation excesses of the top tier stocks. Note that stocks that are added to the index surge on average more than 10% (week before and after), and continue to outperform for the following twelve months. Those that are de-listed, decline sharply.

In 1998, actual index funds attracted nearly $45 billion, more than twice the 1996 level and equal to nearly a quarter of the total committed to all mutual funds. The flagship of the Vanguard Group, its S&P 500 index fund, is about to overtake Fidelity's Magellan as the largest equity fund in the world. But those facts only begin to hint at the real story. When coupled with the "closet" or "enhanced" indexers who masquerade as active managers, the inflows into the S&P 500 indexing strategies have been well over two-thirds of investable equity assets. It is this concentrated capital flood that has driven the prices of the indexes well past economic fundamentals of its underlying components.

The siphoning of capital by the top market tier, has resulted in a liquidity strangulation that is the key reason most legitimate "active" managers continue to under-perform, as value and small cap funds lose assets to closet-indexation and momentum strategists. Moreover, the top tier concentration has as its byproduct, negatively impacted the capital formation efforts of the sub-S&P 500 universe of companies (the internet nuttiness exempted), as the valuations of their equities remain sub-optimal.

The indexation-driven narrowing of the capital flows is the cause of the unprecedented divergence in the valuations between the senior market indexes, such as the S&P 500, NASDAQ 100 and to a lesser extent the Dow Industrials, and the rest of the market of stocks. While the 25 largest technology stocks accounted for 93% of the NASDAQ's 40% advance last year (out of 4500 stocks), twice as many stocks declined in value than advanced, for an average NASDAQ stock loss of over 4%. Thus far in 1999, the same top 25 account for 100% of the year-to-date gain.

Between January of 1996 through February of 1999, the S&P 500 outpaced the Russell 2000 by a margin of more than four to one (101% vs. 24%). More evidence of narrowing: on average, stocks with $20 billion plus market caps were up 26% in 1998, the $5 billion to $20 billion group rose 6%, the $2 billion to $5 billion declined modestly, while the $250 million to $2 billion lost more than 25% in value. Indeed, a full two-thirds of all U.S. stocks lost money in 1998.

The Magellan fund, a prototypical "enhanced" indexer

Let us consider Fidelity's Magellan, still the world's preeminent fund (in terms of size). When the legendary Peter Lynch navigated the portfolio for the thirteen years ending in 1990, the fund at his departure had $12 billion in assets and historically held between one thousand and two thousand stocks. Over his thirteen year stewardship, Mr. Lynch beat the S&P 500 by an extraordinary annual average of thirteen percentage points (29% to 16%). Mr. Lynch's recipe for successful investing was not unlike ours: bottom-up approach to stock picking, based on value and improving earnings prospects, while essentially ignoring the macro-economic vagaries.

After several brief stints with the would be successors to Mr. Lynch, some of whom committed the unforgivable sin of independent, non-consensus thought, Fidelity's management has settled on Mr. Robert Stansky as Magellan's new helmsman.

In the January 21, 1999 issue of *Investors Business Daily*, an article reviewing Magellan's strategy that had delivered a five point outperformance of the S&P 500 for the prior year, noted in relation to the manager's incentive structure that: "the bonus doesn't depend on whether the fund's return rises or falls. Rather, the only thing that matters is whether the fund beats the bogey (S&P 500)". It further points out that among others, **America Online** (with its near infinite valuation), has became the fund's third largest holding, joining the likes of **Microsoft, Intel**, **Cisco Systems** and **Lucent Technologies** among the other technology stocks in the top ten. The latter four's valuations, even after the February's pullbacks, still suggest on average a nearly 60 times multiple for a hoped 30% growth rate (which we believe will not come close to materializing). While **General Electric** remains the largest position (Magellan's cheapest top ten holding, at 35 times earnings for an anticipated 12% EPS growth), Philip Morris (the only stock that was valued below the market multiple) was replaced with Merck, trading at 36 times earnings for a hoped for 14% EPS growth. Those positions not coincidentally mirror the largest market cap components of the S&P 500 index and are very similar to the top holdings of nearly all of Magellan's competitors.

Suffice it to say, Magellan's top ten positions will determine its relative success vis-à-vis the index (and Mr. Stansky's bonus), and thus the strategy is to overweigh in the high flying largest caps, at the expense of the rest of the market. Indeed, even though Magellan now is an $80 billion plus fund, the enhanced indexation strategy has led Mr. Stansky into an ultra-focused concentration, to the point that although the fund is now seven times the size when Mr. Lynch departed, it holds fewer than a quarter of the number of stocks (between 300 and 400). Thus the strategy at Magellan, as well as other S&P 500 benchmarkers is quite transparent. In order to beat the index, and compensate for the inherently higher cost structure of an "active" manager, as well as the necessity of holding some non-performing cash, Magellan has opted to focus ownership on the upper tier of the index, regardless of fundamental valuation considerations.

In round numbers, with three hundred stocks in Magellan's portfolio (with the top 15% percent accounting for nearly 50% of value) it is not surprising that the S&P 500's own individual stocks' performances are highly influenced by their respective market capitalizations. That stratification of the S&P 500 index was very much in evidence during last year's performance. Consider that the top "nifty fifty" of the index outpaced the rest of the index by over 50%, with a 41% return for 1998. The fifty through one hundred largest capitalization stocks in the index were up 27%, 101 through 200 rose 18%, 201 through 300 advanced 9%, 301 through 400 were essentially unchanged, while the smallest fifth of the index declined 17%. Thus the ten largest S&P 500 companies accounted for more than half the gain in the index last year, while the top 35 stocks contributed nearly 80%. Moreover, the top 50 stocks in the S&P 500 now have a multiple of over 50 times estimated 1999 earnings, while the other 450 stocks are closer to a P/E of 20.

Diplomatic veneer aside, Fidelity Magellan is clearly only masquerading as an "actively" managed fund, and in reality is an enhanced S&P indexer, gambling on a dangerous "greater fool" pyramid game with the assets of mostly small and unsophisticated investors. Once the flow of capital reverses, and horrific losses are sustained (there will be no liquidity to depart gracefully), we can only envision a tsunami of class action suits against this bluest of blue-chip funds, with its managers trying to rationalize the economic merits of owning America Online at 300 times earnings.

As an aside, it also puzzles us as to why Mr. Lynch, who has become an omnipresent spokesman for Fidelity's products, is a willing cohort to this, highly risky enterprise. We only suspect that the seduction of the celebrity status he has now acquired is blinding him to the underlying reality. After all, Mr. Lynch proclaims in his pitches that his firm's prodigious research department seeks attractively valued companies with accelerating earnings, yet the reality belies that. Of Fidelity's 10 largest positions, all are high-expectation (suggests likely severe punishment when disappoints), ultra-high beta technology companies (experiencing massive insider selling), which nearly mirror the holdings of the other largest mutual fund institutions (who will likely run for the exits at the same time when the initial exodus begins). None of the top holdings are attractively valued by any objective or historical standards, and all are likely to experience <u>decelerating</u> earnings momentum, that for some commodity technology companies could turn into actual losses within six to twelve months.

We will shortly address the possible solutions to the indexation dilemma and how The Lancer Group is positioning for the inevitable.

Sincerely,

Michael Lauer, Investment Manager

Lancer Offshore, Inc.

Dear Investor: October 24, 2001

The bear market over the past eighteen months made it agonizingly clear that the excessive emphasis on relative performance could, at less accommodating times, result in a significant loss of capital. In the enclosed letter to our shareholders, originally published in March of 1999, we highlighted how the benchmark chasing objective decouples the professional manager (who aims to beat the benchmark) from his key constituent, an investor whose goal it is to generate absolute return. We argued moreover, that the benchmark beating strategies were partially responsible for the market excesses among the big cap growth stock universe (index driving stocks) and the eventual collapse of the same.

The relevance of this issue at this time, we believe, is its demonstrated folly in contrast to the absolute return strategies, typically followed by the hedge fund community. This afternoon I would like to contrast the relative vs. absolute return objectives/strategies, highlighting the risks and rewards of both.

I thank you for your interest and look forward to your questions.

Michael Lauer, Investment Manager

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