THE INTELLIGENT INVESTOR

Here’s One Way
To Beat the Market

BY JASON ZWIEG

Beating the market is easy. Just understated its performance.

Various investment promoters are touting their stock-picking prowess by comparing their returns, including dividends, to the Standard & Poor's 500-stock index without dividends.

It is easier to beat the market when you don’t count its entire return. Over the past decade, according to Standard & Poor’s, the S&P 500 benchmark gained an annual average of just 0.72% without dividends. But with dividends included, the S&P’s total return reached 2.81% annually.

“Here are two main ways to earn returns: price appreciation and income,” says Stephen Horan, head of private wealth management at the CFA Institute. “If you systematically exclude one of them from your benchmark while knowing that your strategy includes them, you’re making a fundamentally unfair comparison.”

When mutual funds compare their return to that of a stock index, they are required by the Securities and Exchange Commission to include dividend income in the performance of the index. Money managers abiding by voluntary guidelines known as the Global Investment Performance Standards must do the same.

But financial advisers and newsletter publishers, among other investment pros, aren’t always covered by such rules.

An article posted on the CME exchange website last November featured a chart comparing the returns on a commodity-trading index to the S&P 500—with a huge gap in favor of the commodity traders. A CME spokesman says the chart was “rather misleading” since it showed the S&P 500 without dividends, incorrectly making stocks look “vastly inferior,” he says. “We disagree with the article and will be taking it down from our website.”

Allan Roth, a financial planner at Wealth Logic in Colorado Springs, Colo., estimates that at least 20 times a year he sees account statements from financial advisers comparing a client’s returns, with dividends, against those of market benchmarks without dividends.

The Aorda portfolios, run by American Optimal Advisors of Gainesville, Fla., compare their results to the S&P 500 without dividends. Aorda’s website shows a cumulative gain for the S&P since January 2005 of 12.5%, although the index re-
turned 28.1% with dividends. “I agree with your arguments,” concedes portfolio manager Stan Uryasev, who says he will be clarifying his disclosures. “Thanks a lot for bringing [the issue] to my attention.”

In April, TheStreet.com sent out an email urging readers to subscribe to Action Alerts PLUS, a trading-tip service from The Street’s co-founder and CNBC host James J. Cramer. Douglas Zitzmann recently posted it on his Fumbled Returns blog.

Sent out under Mr. Cramer’s name, with the subject line “My portfolio is CRUSHING the S&P 500,” the email said Action Alerts PLUS is “producing some truly incredible results.” From Jan. 1, 2002, to April 1, said the email, the portfolio’s “total average return has averaged more than DOUBLE the return of the S&P 500.” An accompanying bar graph showed the S&P 500 returning 15.5%, versus 39.2% for Mr. Cramer’s portfolio.

Incredible indeed, if you include dividends for Mr. Cramer’s portfolio and exclude them for the S&P 500. With dividends, the total return of the S&P over the same period was 38.3%. Viewed this way, Action Alerts PLUS didn’t double the market’s return; it squeaked past by a cumulative 0.9 percentage point. That is before tax and before the annual subscription fee ($299.95 the first year).

“I do not do anything but manage the portfolio,” Mr. Cramer replied in an email response to questions from The Wall Street Journal. He referred inquiries to Gregory Barton, general counsel at TheStreet. Mr. Barton confirmed in an email that Mr. Cramer’s performance does include dividends while the S&P 500 return cited in the promotion doesn’t.

Asked in an interview whether the comparison was fair, Mr. Barton said that “we have recently added an update to the AAP website to show performance information for the S&P 500 plus dividends.” He later said the update was posted “within the past week.”

TheStreet isn’t alone among newsletter publishers. Consider The Proactive Fund Investor, an online service edited by Bill Donoghue and distributed by MarketWatch, which, like The Wall Street Journal, is published by Dow Jones. The newsletter recently compared its “total return” to that of the S&P 500—without counting the dividends on the index.

“We don’t make a practice of promoting the performance of [our] newsletters,” says MarketWatch editor-in-chief David Callaway, “because it inevitably leads to questions of accuracy.”

To approximate Mr. Cramer’s return, you would have had to make an average of 774 trades annually over the past three years, Mr. Barton said. Meanwhile, you could have bought and held an S&P 500 index fund and then done utterly nothing except reinvest your dividends. And you, too, would have more than doubled the market’s return—calculated without dividends.
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How Inflation-Protected Funds Get to Inflate Their Yields

BY JASON ZWEIG

How would you like to triple the yield on your bonds? Most of us can only dream. But look at the eye-popping variation in yields among funds that focus on Treasury inflation-protected securities, or TIPS, the U.S. obligations that rise in value as the consumer-price index goes up.

Among the 173 TIPS mutual funds tracked by Morningstar, the reported “SEC yields” as of March 31 ranged from minus-0.77% to 5.58%, with 12 funds yielding at least 5%. Four of the seven exchange-traded funds that specialize in TIPS displayed yields greater than 5%, with Pimco 15+ Year U.S. TIPS Index leading the pack at 6.07%.

Yet no TIPS yield more than 1.75%. How could anyone but an alchemist generate 5% or more out of 1.75% or less?

The answer lies hidden in the term “SEC yield.” In 1988, the Securities and Exchange Commission forced funds to include only dividends and interest income in the yield that they must show investors. The return on TIPS, however, comes not just from interest income but also from any adjustment in value as inflation rises.

The SEC hasn’t issued any guidance to fund companies on how to handle this peculiarity when they show standardized yields, says Gene Gohike, associate director for examinations at the agency. As a result, firms are free to do more or less as they please, without running afoul of the rules.

Given the way many TIPS funds interpret the SEC yield formula, the change in inflation over the latest reported month gets added to interest income to produce an annualized figure. Thus, in months that capture a small inflation change, SEC yields on TIPS funds will be low. In months like April, when the rise in the Treasury’s inflation value was about 0.5%, SEC yields can brush 6%.

The inflation change upon which TIPS funds will be basing their SEC yields in May will be nearly 1%, notes Dan Dekter, chief investment officer at Smith Breeden Associates in Durham, N.C. That suggests some funds might soon sport much higher yields.

A few brave TIPS funds back the inflation adjustment out of the SEC yield, producing a much smaller number often called “real yield.”

“It hurts us in a sense,” says Ken Volpert, head of taxable bonds at Vanguard Group. “But at least we’re not getting people making misjudgments based on unsustainable yields.” At iShares, the website displays four additional types of yield calculations on its TIPS portfolios—most of them considerably lower than the SEC number. “Investors need to understand what yield they’re getting,” says Matt Tucker, a managing director at iShares.

Inflation-protected mutual funds and ETFs command $110 billion in assets and have taken in $35 billion in new investment over the past two years, according to Morningstar.

“I’m absolutely confident that a lot of these investors didn’t have a clear understanding,” says Todd Petzel, chief investment officer at Offit Capital Advisors in New York. “They saw high past performance, then they saw an SEC yield that was much more attractive than in a conventional bond fund and thought the higher yield will protect them. But the assumptions behind the SEC yield are not clear.”

“It would seem to be a risk area, because these funds are fairly popular at this moment,” says Mr. Gohike of the SEC. “Investors ought to be getting appropriate information on what the return is likely to be. Maybe [the SEC] ought to dig down deeper and take a look at how funds are handling this,” adds Mr. Gohike, who is about to retire from the agency.

This week, the Schwab U.S. TIPS ETF reported a 5.64% SEC yield. “We feel that including the inflation adjust-
THE INTELLIGENT INVESTOR | By Jason Zweig

Why Bankers Should Be Grateful for Occupy Wall Street

This Thanksgiving weekend, Wall Street should say a prayer of gratitude for Occupy Wall Street. While some bankers and brokers have sympathized with or supported this ragtag protest movement, others grouse that they are being demonized. But compared with financiers of the past, who faced nasty rhetoric, political hostility and physical danger, today’s bankers and brokers seem like a bunch of babies when they whine about being targeted by these dissidents.

The “Occupy” rhetoric might sound overheated, but it is golden praise alongside what bankers used to hear.

In 1870, the essayist Henry Adams compared the financier Jay Gould to a spider; Joseph Pulitzer, the famous editor, later called Gould “one of the most sinister figures that have ever flitted bat-like across the vision of the American people.”

In 1883, a young New York state legislator named Theodore Roosevelt lambasted “the wealthy criminal class” on Wall Street. In 1910, Sen. Robert LaFollette of Wisconsin called J.P. Morgan “a beefy, red-faced, thick-necked financial bully, drunk with wealth and power.”

Between 1892 and 1911, at least 53 bills were introduced in Congress to stifle speculation and derivatives trading, although none quite became law. No fewer than 21 states—including California, Illinois, Massachusetts, Ohio and Texas—passed laws restricting speculation, short selling or trading in futures or options.

The Occupy Wall Street protesters have also been far more peaceful than their forebears. On the original “Black Friday”—not the shopping day after Thanksgiving, but Sept. 24, 1869, when Jay Gould cornered and crashed the gold market—fury was in the air. “An angry mob gathered...howling for vengeance,” wrote historian Maury Klein in his biography “The Life and Legend of Jay Gould,” and “a company of militia was hurriedly ordered into readiness.” Gould slunk out a backdoor to safety, guarded by a gang of armed thugs.

In 1877, a speculator who had lost money betting against Gould ambushed him on the sidewalk, slugging the financier and then flinging him down an eight-foot flight of stairs into the basement of a barber shop. Gould was battered but unbowed, although he never again walked the streets without a bodyguard.

In 1891, an assassin tried to kill the investment banker Russell Sage by detonating 10 pounds of dynamite. The bomber and Sage’s secretary were killed; Sage survived, perhaps by using a messenger as a human shield. In 1892, an anarchist shot Henry Clay Frick point-blank in the neck; the mogul survived. J.P. Morgan and John D. Rockefeller, among other financial barons, faced frequent death threats.

In September 1920, a bomb went off in a horse-drawn wagon parked in front of J.P. Morgan & Co. on Wall Street, killing 40 people; the criminal was never found.

Wall Street rarely concedes that regulation has made the markets safer not only for investors but for Wall Street itself. Because the public believes that modern regulation enforces standards of fairness that were lacking in the past, bankers and brokers don’t have to fear for their lives when they walk down the sidewalk.

Wall Street hasn’t yet had to answer to a higher authority, either. In 1940, the investing writer Fred Schwed recalled the eve of the Crash of 1929: “There was a luxurious club car which ran each week-day morning into the Pennsylvania Station. When the train stopped, the assorted millionaires who had been playing bridge, reading the paper, and comparing their fortunes, filed out of the front end of the car...Those who needed a nickel in change for the subway ride downtown took one [from a bowl near the door]. They were not expected to put anything back in exchange; this was not money...It was only five cents [roughly 65 cents in 2011 dollars].

“There have been many ex-ize that the bowl didn’t disappear forever after all. Government bailouts in the latest financial crisis distributed billions of free nickels to failing banks—staving off collapse and enabling the banks to speculate anew with cheap money.

Perhaps, as was true after the Crash of 1929, we will only know that this long bear market is over when, at long last, it consumes the people who perpetrated it. Above all, Wall Street should be grateful that Jehovah hasn’t kicked over this bowl of nickels, too—at least, not yet.
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Hi Ho, Silver: Some Fund Investors Could End Up Tarnished

By Jason Zweig

Does every silver cloud have a dark lining? Few assets have been hotter lately than silver, which has gained about 160% over the past year. So far in 2011, four major funds that specialize in the gray metal—iShares Silver Trust, Sprott Physical Silver Trust, ETFs Physical Silver Shares and PowerShares DB Silver Fund—are up between 50% and 59%

The iShares fund has tripled over the past year, to $16.6 billion. It is now the 12th-largest exchange-traded fund in the U.S. and holds about one-third of all the silver bullion on earth.

Money always chases performance, but when returns get this glittery, the chase becomes a frantic sprint. This week, the half-dozen silver ETFs commanded more than $20 billion in assets, up 23% in three weeks. Nearly 50 million shares of the iShares fund—roughly a quarter of its total capitalization—traded this past Wednesday alone.

In the panic to buy a silver fund before the metal goes up even more, investors may be overlooking some of the fundamental oddities and potential risks of these funds.

Take the Sprott fund, which is in such hot demand that buyers this week were paying $1.22 for every dollar’s worth of silver in the portfolio.

Sprott, based in Toronto, is structured as a closed-end fund. Because the manager doesn’t issue new shares, anyone who wants to buy into the fund must buy from another shareholder on the open market. At last count, the silver in the fund was worth $18.15 a share—but the market price of the fund’s shares was $22.11, a

22% premium over their net asset value.

Why would anyone pay $1.22 on the dollar for an asset that has already delivered blinding returns?

For one thing, buyers seem attracted to Sprott’s unusual storage mechanism. The fund keeps its silver ingots at the Royal Canadian Mint. To many of the folks who buy precious metals as a hedge against financial catastrophe, that seems like a safer haven than the basement of a commercial bank—where most other funds store their silver.

Also, big holders of the Sprott fund can redeem their shares to Sprott for solid bars of pure silver—a comfort in a world of currencies that are becoming cheesier by the day.

Furthermore, Sprott offers an unusual tax benefit: If, when you file your taxes for the year you bought the fund, you append an obscure Internal Revenue Service document called Form 8621, then your future capital gains from selling the Sprott fund will be taxed at just 15%—the same rate you pay on a conventional stock. It is rare to get such a good tax deal on a holding in the commodities market.

But investors might wish to dig deeper.

In a filing with the Securities and Exchange Commission this week, Sprott registered to lift the sale restrictions on the 26% of the fund’s total shares (or “units”) that the manager bought for its own accounts at $10 apiece when the fund opened last November. Until now, those shares have been held off the market by chief executive Eric Sprott and several affiliates of the firm.

A person familiar with the operations of the fund said that Mr. Sprott was on vacation this week and that the sale, if any, of these shares would be at Mr. Sprott’s discretion.

However, now that the registration has been filed with the SEC, they can be sold at any time, which would increase the number of the fund’s shares available to trade and could depress the price.

The alluring option of redeeming Sprott units for silver applies only to investors who hold at least 25,786 units at today’s prices, according to the person familiar with the fund. Yes, you could get a Brink’s truck to pull up in front of your house with a glittering haul of silver when you sell the fund—but only if you held $600,000 or more. There are far easier and cheaper ways to buy silver.

As for the special tax treatment on Sprott, it applies exclusively to investors who make the required IRS
filing. Otherwise you could owe back taxes at ordinary-income rates, plus interest. "If you do it wrong, you’re really screwing yourself up," warns Robert Gordon, president of Twenty-First Securities Corp.

The other silver funds, like most commodity ETFs, are no tax bargain either. If precious metals stay hot, then your future capital gains will generally be taxed at 28% in the iShares and ETFs funds and at an effective rate of 23% in the PowerShares fund.

In the real world, not many people think of silver as a metal that gets too hot to touch. In the financial world, it seems to be getting hot enough to give unwary investors a scalding.
THE INTELLIGENT INVESTOR

Forget About Black Swans, the One Floating Ahead Is Neon

BY JASON ZWEIG

You’ve heard of black swans—events that are unthinkably rare, immensely important, and as unpredictable in advance as they are inevitable in hindsight. Now, with no one ruling out a default or downgrade of U.S. Treasury debt, investors face a new kind of threat: what we will call the neon swan, an event that is unthinkably rare, immensely important and blindingly obvious.

The politicians in Washington have a couple weeks to forestall a disaster that has begun to seem like a certainty. Investors everywhere are perfectly aware of the consequences if Congress and the Obama administration can’t strike a deal: The U.S. is likely to lose its privileged triple-A credit rating, and corporate bonds and stocks alike could plummet in response.

As Nassim Nicholas Taleb’s bestseller “The Black Swan” made clear, the human mind is poorly equipped to prepare us for rare, important and unpredictable events. But maybe our minds—and our markets—aren’t very well equipped to protect us against neon swans, either.

Many investors seem to be coping with what seems like an obvious risk simply by closing their eyes.

Theodore Aronson, a partner at Aronson Johnson Ortiz in Philadelphia, oversees $21 billion in stock investments for 90 institutional clients. In roughly 75 conference calls with clients over the past few weeks, says Mr. Aronson, no one has asked whether a different investing approach is needed in light of the risk that a U.S. debt crisis might make the markets go haywire.

“I find it amazing,” he says, “that we have not gotten a single question or comment about it.”

Then again, Mr. Aronson adds, his firm hasn’t done anything to protect against the risk of a crisis in the Treasury market. “We’ve thought about it, but we don’t know what to do,” he says. “As best we can figure it, there isn’t anything we can do.”

Some investors are worried enough to ask questions, but not many have taken any action yet, says Paul LaRock, a principal at Treasury Strategies, a Chicago-based firm that helps large corporations manage their cash. “Companies are pulling out their investment policies and rereading them,” he says. One major firm on the East Coast, Mr. LaRock says, asked this week whether its investment-policy statement, which places “no limit” on its holdings of U.S. Treasurys in the company’s cash balances, needs to be amended to keep the company’s coffers secure.

Mr. LaRock says the client is still mulling that question. And, even with disaster seeming inevitable, many investors may be paralyzed by uncertainty. “U.S. government secu-

ities have long been the yardstick for measuring the risk of most other investments,” he says. “One of the most disturbing things that we have to get our minds around should the unthinkable happen,” he adds, “is that the reference point for pricing securities around the globe could be lost. No one can predict what would happen worldwide.”

Not that Treasurys will necessarily get pounded. If the U.S. defaults or its credit rating is downgraded, says William Bernstein of Efficient Frontier Advisors in Eastford, Conn., Treasury prices would probably go to 97 or 98, losing only a few percentage points in value. “You’re not going to wake up one morning over the next couple of weeks and find they’re priced at 50 cents on the dollar,” says Mr. Bernstein.

“It is absolutely inconceivable that we would flat-out default and not pay anything,” he adds. “The worst-case scenario is a very temporary payment problem, and I think the Treasury market knows that.”

But the ripple effects could be considerable. Mr. Bernstein expects corporate and municipal bonds to drop much more drastically if the Treasury market is hit by default or downgrade. And stocks, he says, could be massacred. For investors with cash and courage, a crisis in U.S. Treasurys might well pose a historic buying opportunity. If, instead, it turns out to be “like a giant asteroid hitting the earth, Mr. Bernstein says, “then there isn’t much of anything that’s likely to protect you.”

Thus, keeping a sizable balance in short-term Treasurys—the securities that suddenly feel shaky—is probably a good idea in case stocks and bonds go on sale. You can make a sudden move into gold or cash, but they carry risks of their own, especially if the debt crisis somehow gets averted.

It is important not to be complacent. If you are blindsided by bad news that was staring you in the face for weeks before it came to pass, you will feel like a fool. On the other hand, the forces that do the worst damage to markets “are never the ones that you think are going to get you,” Mr. Bernstein says. Waiting may well be the wisest course this time. You don’t want to ignore a neon swan, but you don’t want to overreact to it only to have it swim quietly away.