Hope Is Not a Strategy

Past is Not Prologue, and Hope Is Not a Strategy
Eliminating Negative Alpha
Our Biggest Bet is Equities – Does Cap Weighting Weigh Us Down??
Practicing What We Preach
Update – Fundamental Index™ Today
New Orleans, London and South Africa

By John Mauldin

Investors are constantly seeking “alpha,” that elusive substance which yields returns in excess of a simple market portfolio. While I am flying today to Prague, this week good friend Rob Arnott teams up with associate John West to show that it is just as important to eliminate negative alpha. In fact, you could find an extra 2-4% in your returns just by doing so!

Rob starts with showing us what type of returns one can expect over the next ten years from the typical US market fund, and then shows how to remove some of the drags of negative alpha which hurt those returns. This is a very important piece and one I think you will want to read more than once.

Rob is the founder and head of Research Affiliates. He has published scores of articles in various financial journals, won four Graham and Dodd Scrolls for his writing, travels and is the keynote speaker at too many conferences to mention and is recognized as one of the top financial minds in the world. He wrote a chapter in my book, Just One Thing.

He is also the creator of the Fundamental Index (patent pending) which is exploding onto the market. When I first wrote about it three (maybe four? Time flies.) years ago, I said that fundamental indexes would be the fastest new investing concept to grow from zero to $100 billion in history. Today there is almost $20 billion invested in various kinds of fundamental indexes all over the world, and the number is growing rapidly, as some of the largest pension and institutional investors in the world are adopting the concept to replace their traditional index investing. At the end of this letter, I mention a few places where you can find funds and information.

But first, let me mention that I will be speaking at the New Orleans Investment Conference October xx-xx (Doug, insert date and links). This is the grand-daddy of all investment conferences and features some of the top investment analyst and minds in the country. You should check it out and if you are there make sure and look me up. (Insert link)

Now, let’s turn it over to Rob and John.

Guest Column by Rob Arnott and John West, of Research Affiliates, LLC

Past is Not Prologue, and
Hope Is Not a Strategy
The capital markets of the last quarter century have been incredibly generous to us. Since mid-1982, the S&P 500 index has advanced at a solid 13.9% annual clip, while 10-year Treasury bonds have posted annualized returns of 9.8%. With annual inflation averaging just over 3%, this means that investors have seen their real wealth double every seven years in stocks and every 11 years in bonds. But, past is not prologue.

Would a bond investor, looking at 25-year returns of 10% and current long bond yields of 5% be foolish enough to expect the next 25 years to deliver 10%? Of course not. They’d recognize that yields started in 1982 at 14% and had plunged to 5% over the next 25 years, earning hefty capital gains on top of a yield averaging 7% over this span. With current yields of 5%, they’d expect 5%.

So, if stocks were yielding 6% in 1982, and are now yielding 1.8%, should we expect to repeat the 13.9% of the past quarter-century? Of course not. On average, 5% a year came from capital gains attributable to multiple expansion – over and above what growing earnings and dividends contributed. Take that away, and we’re at 9%. After all, that’s what we’d have earned if dividend yields still matched the average yield of the quarter century. But, even that’s too aggressive. Dividend yields are 2% lower than their average during this span and 4% lower than the starting yield of 1982. Take 2-4% away, and we should expect 5-7% from our stocks in the years ahead.

Over the past century, dividends have provided over two-thirds of the real returns earned in US stocks. Today, they hover well under 2%, while nominal bond yields are in the 5% range. Simple arithmetic points to 5% returns for bonds and 5-7% for stocks – if their respective yields don’t rise in the years ahead! Rising yields and shrinking P/E ratios would mean capital losses which would reduce returns below these levels, much as falling yields and rising multiples fueled the wonderful returns of the past 25 years.

A lot of investors, even professional institutional investors, aided and abetted by their consultants and actuaries, don’t like this arithmetic. So, they dismiss it, preferring to forecast the future by extrapolating the past. This is perhaps the worst possible way to construct expectations. It led actuaries to assign very low return assumptions (6% was typical) for pension funds in 1982, at a time when 14% could be locked in with government bonds, and when stocks were producing that same 6% in dividend yield alone, without even allowing for any growth, capital appreciation or inflation, all of which could, and did, add mightily atop that 6% yield. Why such low expectations? Because returns from 1965 to 1982 had been wretched.

Extrapolating the past similarly led to 10% and higher return assumptions at the peak of the bubble in 2000, at a time when bond yields were 6% and stocks were offering a scant 1% yield. Why such high expectations in a world of low yields? Because returns from 1982 to 1999 had been truly extraordinary. In 2000, I wrote a short paper entitled “Death of the Risk Premium,” with Ron Ryan, which was received with widespread derision, but ultimately proved correct: plain old 10-year government bonds have produced higher returns than stocks since then, by a cumulative margin of over 30%, despite the durable
Hope Is Not a Strategy

bull market since 2002. And, even if we include the bubble of 1998-2000, stocks have beaten bonds by well under 1% per year over the past decade.

Today, no matter how fuzzy the arithmetic, it is difficult to justify long-term returns from conventional stock and bond balanced portfolios exceeding 5-7%. We can decry the math and its conclusions, but investors can only dismiss it outright at their peril. Since most plan on 8-10% returns (if not more!), the vast majority of long-term investors are confronted with a large shortfall between likely portfolio returns and what they hope to achieve.

Worse, if inflation drains off 2-3% a year – it would be awfully dangerous to count on a more benign long-term inflation outcome than this – and if taxes take away one-third of our 5-7% total return, we’re left with pretty close to zero real return, net of taxes and inflation. Yikes.

Many, with spending plans that require 8-9% returns, hope such seemingly-bleak expectations prove off the mark. But hope is not a strategy. Rationally-inclined investors are grudgingly beginning to accept this likely reality. They recognize that it’s far more sensible to take an alternative view: 5-7% returns aren’t really all that bad, and so perhaps we should hope for more, aspire for more, develop strategies aimed at achieving more, but accept 5-7% as the base case scenario.

Eliminating Negative Alpha

Noting the gap between expected and required returns, many investors increasingly turn to “alpha” (value added from investor skill) as the elixir to cure their long term ailment. Meander through just about any industry publication and it is impossible to avoid the cascade of references on all things alpha - the quest for alpha, bids to increase alpha, alpha overlays, currency alpha, loosening constraints for alpha and the list goes on. It is almost as if manager skill is an assured and harvestable commodity. The very word “alpha” triggers feel-good pheromones in investors, as reliably as chocolate truffles or love. Few people bother to discuss the fact that alpha is a zero-sum game, with an average alpha of zero – less the costs associated with the quest for alpha. This means that most alpha is negative!

In investing, what is comfortable is rarely profitable. If the crowd is hell-bent on unearthing positive alpha, our own contrarian inclination points us in a different direction – very few of today's market participants are focusing as aggressively on eliminating negative alpha. Seeking, identifying and eliminating negative alpha is as profitable as seeking, identifying and employing sources of positive alpha.

We define negative alpha as the slippage investors unnecessarily incur in the ongoing management of their portfolios. A fancier term would be implementation shortfall. Eliminating all these various mistakes is not only profitable, it’s vastly easier than competing with the crowd of alpha chasers.
Four major sources of negative alpha will be covered in today's discussion. No doubt, there are countless more that deserve additional consideration. Certainly, cost is an obvious example: all other things equal, the lower fee alternative will outperform; but, I think that is fairly self-evident. These four require a little more discussion as avoiding them requires considerable more effort than simply lining up expense ratios. They are:

1. Equity Concentration
2. Ignoring Rebalancing Opportunities
3. Chasing Winners
4. Cap Weighting in Stocks

**Equity Concentration.** Holding equities for the long run is a nearly universal mantra in our industry but there are many markets that appear to offer a “risk premium,” ranging from commodities to emerging markets bonds, from real estate to timberland. Reliance on significant equity allocations, while ignoring these other markets, limits our ability to reduce portfolio risk through diversification. One of the best kept secrets in investing is the miniscule diversification achieved in the classic 60/40 traditional balanced portfolio. Due to their significantly higher volatility, sizable equity declines overwhelm bonds in this supposedly "balanced" construct. For this reason, the 60/40 mix has very nearly a 99% correlation with the S&P 500! If we use other “risky” markets selectively, opportunistically when they’re offering premium yields, and on a scale large enough to matter, we can earn equity-like returns at far lower risk.

Not many recall the current decade as an easy time to make solid profits. Even the bull market from late-2002 until mid-2007 barely recovered the 2000-02 equity market losses for most investors. But as Figure 1 illustrates, for those who were not invested in an equity-dominated portfolio, especially those willing to stray outside of both mainstream stocks and bonds, many asset classes have delivered lofty returns. Indeed, most people would be surprised to learn that the average return of this list of markets was essentially the same: 9.3% per year in the first six years and 8.7% in the more recent six years!

Figure 1. Comparing Fifteen Markets from 1995-2006
Diversified portfolio’s Sharpe Ratio of X.X trounces the 60/40’s X.X. Which return stream would a rational investor desire? In widening the opportunity set to include meaningful allocations to alternative strategies, we can avoid the negative alpha due to an over-reliance on equities and likely earn meaningful excess returns.

**Rebalancing.** Buying low and selling high – through rebalancing – is a perennially underrated investment choice. Neglecting this simple exercise is an almost universal source of negative alpha, especially when we take account of risk. The strong tendency of the capital markets to mean revert translates to incremental profits, for those willing to sell their long-term winners and buy their long-term losers.

Still, it’s not an easy discipline to embrace. Consider Figure 1 again. Imagine the courage required to sell the S&P 500 and buy Emerging Markets at the start of our current decade, after six years in which US stocks had risen 219% and Emerging Market Stocks had lost one-fourth of their value.

A disciplined rebalancing policy adds about a half-percent to risk-adjusted returns for a well-diversified portfolio. [I have written a couple of articles demonstrating this result, over long spans, which I will send to John and he will post in the future.] Suppose we started in 1995, with $100 in each of the fifteen asset classes listed above. By the end of the 12 years, our $1500 would have grown to $4412. If we did just one rebalance, halfway through the 12 years, putting one-fifteenth of our money in each of these markets, we’d have boosted our final wealth by $165, or 11% of our starting portfolio value! Remarkably, this result required one set of trades totaling just 12% of the portfolio, effectively an average of 1% turnover per year.

Of course, these excess returns solely accrue to those willing to look uncertainty in the eye and follow through. Indeed, eliminating the slippage is far easier said than done. The more comfortable course, “waiting for things to settle down,” allows the asset mix to drift with the whims of the capital markets. In so doing, rebalancing opportunities are squandered with the portfolio suffering the associated negative alpha.

**Chasing winners.** Chasing the latest investment craze is incredibly easy, as we are bombarded with success stories at every turn - the neighbor who got in on the hot IPO, our brother-in-law with his 30% hedge fund return last year, and the advertising campaigns of the top mutual fund companies, proclaiming their latest star performers (how often does a mutual fund company take out ads listing their best and worst five funds?!). Collectively, these stimuli lure us like a siren's song to chase the latest winners, be they asset classes, managed portfolios, or individual stocks. In the case of funds, the investment is often then sold at the bottom of its performance cycle, after it’s become a “proven” loser. Inevitably, it is replaced with a “good manager” who has experienced strong results recently. Of course, these replacement firms’ performance is near high tide and begins to recede not long after retention.

This practice is the equivalent of selling low and buying high and its damage to investor wealth is devastating. To quantify this negative alpha, we turn to a 2005 study by Russel...
Kinnel of Morningstar that dramatically illustrates the consequences of chasing winners (“Mind the Gap: How Good Funds Can Yield Bad Results,” *Morningstar Fund Investor*, July). In 17 equity mutual fund categories, the average dollar weighted returns (return to the investors) were compared with time weighted returns (return to the fund) over the previous 10 years. Kinnel found every single category’s dollar return trailed its time weighted return with the average slippage amounting to 2.8% annually- a damning indictment of investors’ tendency to chase recent performance.

An example is probably in order, to illustrate the simple but nasty mathematics behind this shortfall. A small fund with $100 million of assets produces an excellent three-year return of 21% per year. Investors take note and, consistent with history, move money into this hot new portfolio so that over the next three years the fund's asset base swells to $1 billion. Meanwhile, the strong performance evaporates and the fund finishes with a 0% return in the next three years. On a time weighted basis, the fund delivered an average of 10% per year, compounded. But on a dollar weighted basis the fund earned a scant 1.9%, indicating a slippage of 8.1% per year. Kinnel’s study showed annual slippage of over 11% for the average investor in Technology funds. Talk about impatient investors!

The urge to act upon recent successes and abandon yesterday’s laggards is so incredibly powerful that most investors, individual and institutional alike, lose the requisite patience and throw away a sizeable portion of the equity market’s return.

**Cap-Weighting in Stocks.** The last source of negative alpha happens to occur in the asset class where most investors have their greatest exposure – equities. As we will see, the indexes that we rely upon, by their very construction, fail to enjoy both of the previous sources of alpha. They do not rebalance when any stocks advance well ahead of – or retreat far below – their fundamentals. And they chase winners, by adding stocks to the portfolio after they’ve been on a roll and dropping them after they’ve faltered badly.

The shortfall from traditional active management in stocks is well-known: the combined handicaps of management fees and trading costs cause the average fund to underperform the S&P 500 by 1-2% per year over long periods of time. A revolutionary concept thirty years ago, this is common knowledge today and so investors have been increasingly driven towards index funds.

But stock index funds also incur slippage. Virtually all traditional indexes, and their associated index funds and ETF’s, use market capitalization, essentially the total value that Wall Street assigns to the enterprise, to determine the weight each security receives. Those shares priced above their eventual intrinsic value (think AOL in 1999) will have an erroneously high capitalization and, therefore, a high index weighting. An indexed portfolio, weighted by capitalization, will invest most of our money in these stocks, each of which will eventually underperform as the market seeks out the intrinsic value. Stocks priced below eventual intrinsic value will have an erroneously low capitalization, hence index weighting, and will offer a performance boost. *However, the relative losses of the overpriced stocks overwhelm the relative gains of the underpriced stocks because the*
underpriced stocks comprise less of the portfolio. In this manner, linking portfolio weight to security price – so that more than half of a capitalization-weighted portfolio will be in overpriced stocks – introduces a return drag.

Investors on both sides of the active/passive debate should be incredibly frustrated by this phenomenon. Some know there are mispriced stocks and so they seek out well-managed mutual funds to identify underpriced companies. Their hopes are, of course, dashed when these funds fail to perform despite an environment that provides numerous opportunities. Seeing these failures, the indexers eschew the performance game and invest in their cap-weighted market proxies. Their confidence shrinks when over time they see their reliable index reliably load up on shares of companies that are later proven to be dramatically overpriced.

The Fundamental Index concept was developed to address this structural return drag. By weighting securities on fundamental metrics of company size like sales or earnings, we sever the link between our allocation to a stock and its over- or under-valuation. Using a valuation-indifferent weighting scheme should leave the resulting portfolio with roughly equal parts overpriced and underpriced securities, even without knowing which ones are which! As these pricing errors are corrected, the relative gains and losses cancel each other out.

The construction is a relatively simple exercise. For example, if Microsoft's sales represented 4% of the top 1000 sales companies, it would receive a 4% weight in a sales index. In the Research Affiliates Fundamental Index (RAFI®), we repeat the same exercise for Microsoft with dividends paid, book value, and free cash flow. Taking a simple average of each company’s relative scale in these four financial measures gives us a pretty good indication of its economic footprint. Market capitalization, in contrast, measures Wall Street’s estimate of a company’s long-term future growth prospects and future economic footprint, for which the market prepays as if that future is a fait accompli!

John Maynard Keynes was not only one of the most important economists ever, he was also a legendary investor. He said that he chose not to invest in speculations and expectations, preferring to invest in what companies own and produce. What better reflects the market’s consensus for expectations and speculations than market capitalization weighting? What better reflects what companies own, produce, and deliver to their shareholders, than weighting our portfolio by companies’ sales, profits, net assets (book value) and dividends?

In using such “Main Street” size metrics, the resulting Fundamental Index portfolio is largely representative of today's economy. To reflect the changing economy, the index is rebalanced annually. Furthermore, it retains virtually all of the positive attributes normally associated with passive investing – massive diversification, liquidity, transparency, and low turnover.
But most importantly, the structural negative alpha of overweighting overpriced securities and underweighting undervalued shares is gone. What’s that worth? Over the forty-five year evaluation period in the US, the Fundamental Index concept produced excess returns of 2% with less volatility than similar cap-weighted indices in large company equities. Interestingly, it makes comparatively little difference which fundamental metric one chooses. Selecting and weighting companies by sales, by profits, by book value, by dividends, even by the number of employees, all produce results within 50 basis points per year of the RAFI composite. The sole outlier, capitalization-weighting, falls 220 basis points per year behind the average Fundamental Index result. That’s enough to make the difference between making 80 times our money versus making 200 times our money, over the last 45 years. What an outlier!

Nomura Securities replicated this work in all 23 countries in the MSCI and FTSE developed world indexes, and found that it outpaced capitalization weighting in 23 countries out of 23, with no exceptions, by an average of 2.6% per annum over the span from 1988 to mid-2005. The Fundamental Index portfolio even outpaces capitalization-weighting in all ten of the global market sectors tracked by FTSE (technology, health care, capital goods, etc.), with no exceptions, from 1990 to date.

The Fundamental Index advantage only widens in inefficient markets like small companies and emerging markets. These markets have diminished coverage by Wall Street and institutional managers leading to a greater likelihood of pricing errors. The cap-weighted index suffers a greater return drag as the frequency and magnitude of mispricings proliferate – even more money is allocated to the overvalued and even less is allocated to the undervalued. Imagine a passive strategy outperforming standard benchmarks by 3.5% in small companies and nearly 10% in emerging markets; these are the historical results in these markets! This turns the whole notion of index investing upside down – no longer is the index fund an inferior choice in inefficient markets where the potential returns from active management are greatest.

Practicing What We Preach

Most wealth advisors have seen their clients drawn into the first three errors, the first three sources of negative alpha. Significant positive returns in equities, or any investment category for that matter, tempt clients to forgo proper diversification. Rebalancing often implies adding assets to the worst performers, what many refer to as “watering the weeds.” But, as any gardener knows, weeds can grow like crazy! The stellar results of recent winners make them irresistible.

For this reason, investment policies are developed to mitigate these behaviors. The resulting stable asset allocation structures, automatic rebalancing procedures and long-term performance criteria are time-tested and theoretically sound investment practices. One of the main contributions that the best wealth advisors make to their clients’ success is to effect these policies and, in so doing, to help their clients avoid simple and costly errors. They ensure patience, discipline, and commitment – three traits vital to long-term investment success.
The return drag associated with cap-weighting, however, is a relatively new concept in portfolio slippage. It has stirred massive controversy in the practitioner and academic communities, because it calls into question some of the core precepts of modern finance and challenges some of the best-respected (and largest) product areas in the investment world. But a sizable portion of the advantage of the Fundamental Index concept, is attributable to the fact that traditional indexes ignore the simple Investing 101 tactics we just reviewed.

The S&P 500 Index chases performance and allocates more of our money to recent winners. A stock that doubles in price gets double the weight solely because it doubled in price. How else to explain Cisco’s weight in the index increasing from 0.4% to 4.0% in the last two years of the bubble? Did its weight rise ten-fold because it had become vastly more attractive, as its P/E rose from 30 to 130? Of course not. It’s weight rose ten-fold because its price had risen ten-fold relative to the rest of the market. Ironically, as its stock price cratered, the company continued to deliver growth well ahead of the broad economy, but not enough to justify its astronomical multiples at that time.

The cap-weighted index doesn’t practice periodic rebalancing, preferring to not buy low and sell high. The only time transactions occur is when new stocks are added and old ones deleted. Very often new stocks will be ones that have done well recently, not necessarily those that will do well in the future. And the deletions, unless they’re takeovers, are inevitably companies that have fallen badly relative to the rest of the market.

Combined, the tendency to allocate more to recent darlings and bypassing rebalancing can lead to a relatively less diversified equity portfolio in times of bubbles and fads. As economic sectors surge in price, a natural side effect is a more heavily concentrated cap-weighted index portfolio. In extreme instances like the TMT bubble of 1998-2000, the outstanding diversification typical of traditional index funds is severely compromised. In the past half century, no economic sector that exceeded 25% of the S&P 500 ever delivered enough future success to justify that immense allocation. Technology in 2000 was the latest victim of this pattern.

*Why emphasize these time tested methods – diversification, rebalancing and avoiding chasing winners - to asset classes and managers, and then turn around and invest in an index fund that largely ignores them in the cross section of the equity market?*

The Fundamental Index concept meanwhile avoids returns chasing behavior, practices rebalancing, and achieves sizeable diversification even when it is out of favor. Stocks that double in price aren’t automatically given twice the weight. The annual rebalance ensures discipline and, unlike traditional cap-weighted indexes, forces the portfolio to buy low and sell high. Outperformers are rebalanced back to their economic size with these proceeds invested in shares that have recently fared poorly. As most enterprises’ share prices loosely follow their economic scale, annual turnover remains very low – almost as low as with capitalization-weighting. Weighting by fundamental metrics also
bypasses the pricing bubbles that occasionally pop up in the equity market. All of this is accomplished in a formulaic and easily replicated manner.

**Update – Fundamental Index™ Today**

The Fundamental Index concept isn’t just theory - it is being used by individual equity investors today in a variety of structures. With each passing month, the RAFI methodology is stirring up considerable debate and, we might add, tremendous flows of equity assets. I've never had the privilege to develop an idea which stirred so much controversy and comment, from both practitioners and academics, so quickly. Total RAFI-related assets have grown from less than $1 billion eighteen months ago to nearly $20 billion today (here, I include assets of others’ products that we believe may infringe our pending patents).

The Retrospectives below show a handful of Fundamental Index applications, including US large and small, International, Pan-European, Japan, to name a few. There are other indexes, not shown, covering all 23 countries in the FTSE and MSCI developed world indices, NASDAQ companies, international small companies and 12 of the largest Emerging Markets. These are simple, passive index results, not the results for managed funds. RAFI strategies are distributed through our affiliates, who can provide the results on their own products. The Inception-to-Date results go back as far as FTSE, the global index provider has ratified these results; there are longer-term results, not yet confirmed by a major index provider, going back as far as 1940 in the US and 1984 elsewhere, which suggest similar long-term results.

<table>
<thead>
<tr>
<th>FTSE-RAFI™ Strategies</th>
<th>YTD, as of 24 August 2007</th>
<th>Annualized ITD through July 31, 2007*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>RAFI™</td>
<td>Benchmark</td>
</tr>
<tr>
<td>RAFI™ 1000 vs S&amp;P 500</td>
<td>5.1%</td>
<td>5.5%</td>
</tr>
<tr>
<td>RAFI™ 1500 vs Russell 2000</td>
<td>3.7%</td>
<td>2.2%</td>
</tr>
<tr>
<td>RAFI Global ex US vs MSCI EAFE</td>
<td>8.0%</td>
<td>6.2%</td>
</tr>
<tr>
<td>RAFI Europe vs MSCI Europe</td>
<td>5.8%</td>
<td>4.8%</td>
</tr>
<tr>
<td>RAFI Japan vs. MSCI Japan</td>
<td>-4.2%</td>
<td>-4.4%</td>
</tr>
</tbody>
</table>

This year, for instance, the RAFI™ indexes are ahead in all areas except US large companies. Even in US large companies, they lag by only 0.4%, despite what one hedge fund manager characterized as “the largest de-leveraging in history,” which led many quant-value managers to underperform by sometimes immense margins. This small shortfall occurs after outperforming by over 5% cumulatively in the prior two years. The FTSE RAFI 1500 is ahead of the Russell 2000 by 150 basis points despite a nearly 900 basis point edge of small cap growth over small cap value. The diversified overseas variant, the FTSE RAFI Global ex-US Index, also is showing solid value-added amidst the year’s volatility and value underperformance.

We think these results are compelling to any but the most committed advocates of efficient markets and conventional indexing. Keep in mind as you review this material.
that this is not stock picking, nor is it a quantitative active management model. It's just a "fundamentally" different sort of broad market index!

**Getting Fundamental**

(Back to John.) Thanks, Rob, for such a great article. As I mentioned at the beginning of the e-letter, I am a big fan of Rob and the concept of fundamental indexing. It is an idea that just makes sense. I think that we will look back in ten years and wonder why we used cap-weighted index funds. For those of you that have some of your portfolio in index funds, you should seriously consider switching to a fund that is a fundamental index style. You can get US large and small cap funds (and ETFs), European, Asian, Japanese, international, South Africa, various sector funds and more through ETFs and funds offered by Schwab, Powershares (ETFs), PIMCO, and AssetMark, all of which use Rob’s fundamental analysis.

I can’t get a lot more specific, as everyone has different needs and what may be the right approach for one person would be wrong for others, but in general, I would prefer to substitute a large cap US Fundamental Index fund or ETF for an S&P 500 index fund, as an example. Check with your investment advisor about what is right for you.

**New Orleans, London and South Africa**

I know it sounds like I travel a lot, and I do, but for whatever reason, it seems to run in spurts. I will spend the weekend being tourist in Prague, then on to London. When I get back next Thursday, I have very little on my schedule for the next 9 months. I will be in New Orleans in October (as noted above), in La Jolla for my annual Strategic Investment Conference in April (co-hosted with Altegris Investments), and it now appears that I will be going to South Africa in May. I am sure things will come up, but for right now, my calendar is quite bare. I know my publisher will encourage me to use the time to finish my book, and I should.

I am literally on the plane as I write this, flying from Krakow to Prague. Krakow is a lovely city. I took a tour of the Wieliczka salt mine (http://www.krakow-info.com/wielicz.htm) that has been in operation for 700 years. We went down 135 meters (there is a sanatorium at 200 meters), and some 2,000 different man-made chambers, some of which are huge. An excellent tour, all around. Watching how they mined from medieval times was most fascinating, and gives you an appreciation for not only how truly difficult it was to live and work in another era, but the level of ingenuity of those times.

Earlier in the week I was in Warsaw, which has its own charms, but going through the maze that is the Warsaw Historical Museum and being confronted with the utter devastation of the city by the Germans in retaliation for the uprising in 1944 is sobering. Half of the 1.3 million residents of Warsaw, some 650,000 souls, did not make it to the end of the war. 90% of the city was simply rubble. It says something for the national personality of the Poles that they re-built the city.
Hope Is Not a Strategy

I can hear the engines slowing down, so it is time to put the computer up, get to my hotel, find an internet connection and hit the send button. And maybe I can get another chapter of The Black Swan read. It is a most thought provoking book. Have a great Labor Day weekend.

Your enjoying the luxury of time to think analyst,

John Mauldin