Alice in Russell Land

With apologies to the Jefferson Airplane...

One stock makes you richer
And one stock makes you small
The ones your broker gives you
Don't do anything at all
Go ask Abby
When she's ten feet tall
And if you go chasing growth stocks
You know how hard they fall
Tell 'em a value-buying caterpillar
Has given you the call

The Thanksgiving holiday is as good a time as any to reacquaint ourselves with two literary parables. The first, that of the tortoise and the hare, is readily familiar to all. As long as we are within the animal kingdom on Wall Street, let's remind ourselves as well that while both bulls and bears have their day, pigs receive an unpleasant comeuppance too indelicate for these pages.

The second parable, that of the looking glass in Lewis Carroll's psychedelic classic *Alice in Wonderland*, is that things aren't always as they seem. As we depart the 32nd month of a bear market that forever will be associated with the evisceration of technology and telecommunications, it is hard to believe that Internet poster children such as Amazon.com and eBay have outperformed such seemingly prosaic stocks such as Goodyear, Caterpillar, Boeing and Alcoa over the past five years.

Hares Whomp Tortoises!
Film At 11!

eBay	837.1%
Amazon.com	371.9%
Alcoa	47.0%
Caterpillar	9.0%
Boeing	-23.8%
Goodyear	-84.7%

Total returns since Oct. 31, 1997

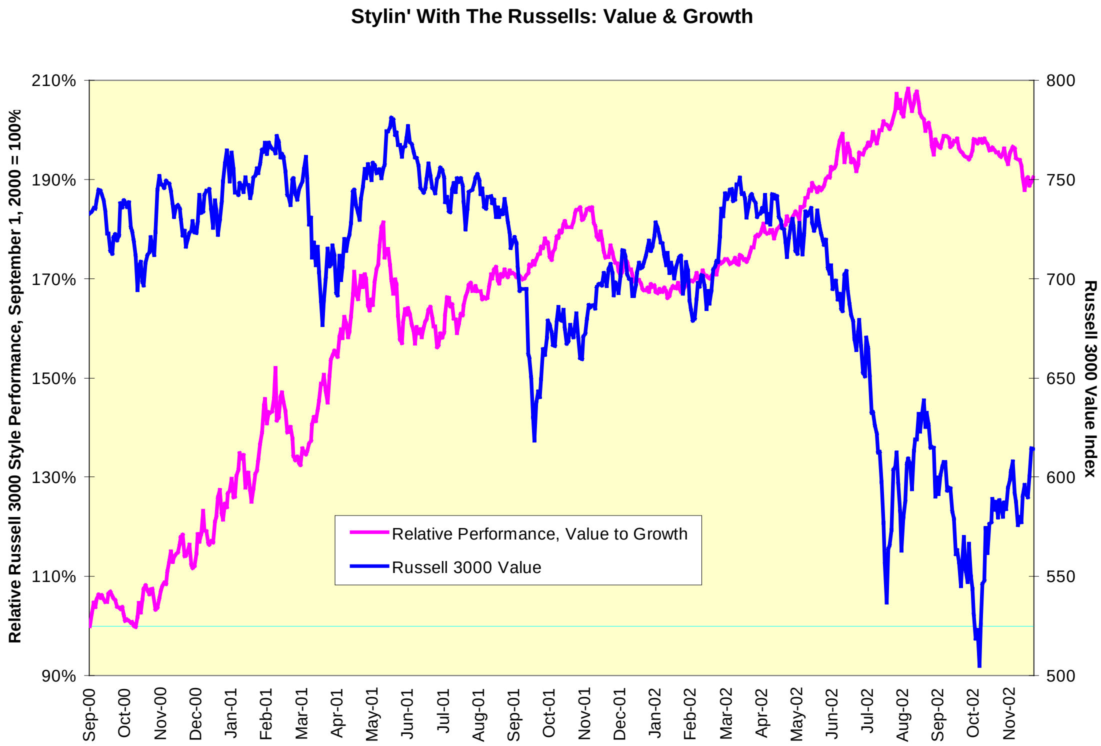
Style And Volatility
The return paths of even the Internet survivors have been anything but smooth, however. While I scorn the attempts at earnings management made by firms such as General Electric as exercises in self-deception, I readily understand the value of stocks on which I may turn my back without fear. Modern portfolio theory is built on the principle of maximizing return while minimizing risk.

This generation of investors now will value risk management and the preservation of capital as much as growth; this does not mean, however, that there will not be prolonged periods over the next decade when bravery will return and growth will be valued more than value will grow.

Let's take a look at the subdivision of the Russell 3000 index, which embraces nearly 98% of the U.S. market's capitalization, into value and growth portions. By way of full disclosure, futures on the Russell ETFs have established themselves as one of the most successful single stock futures for Nasdaq Liffe Markets, for whom I consult.

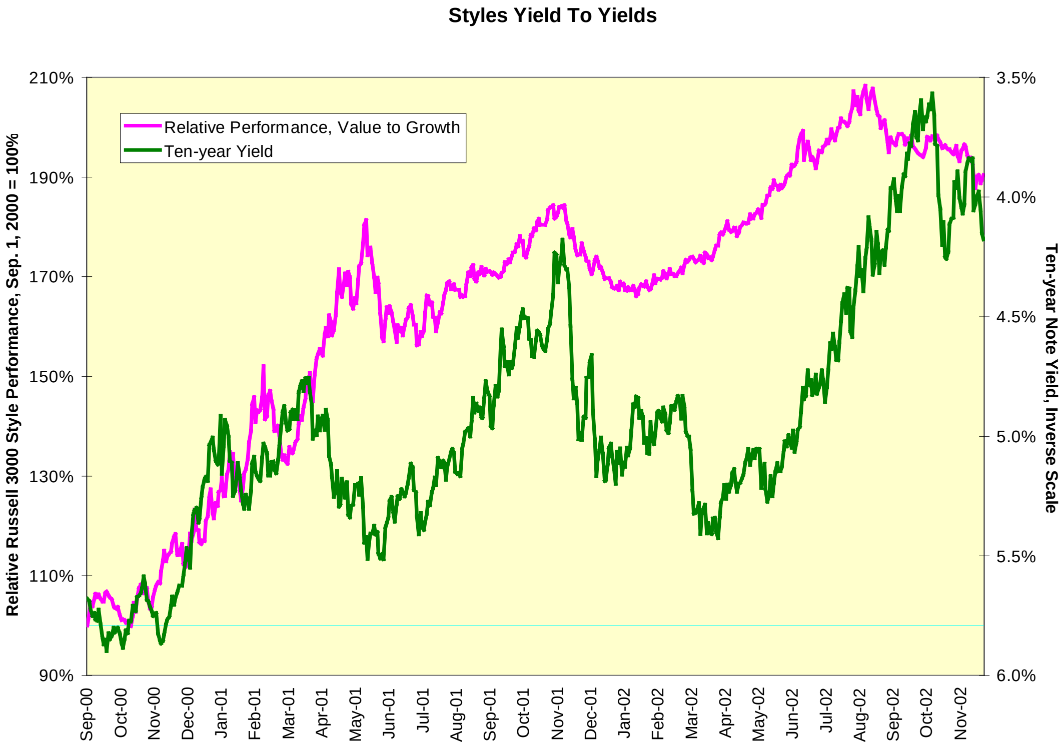
The Russell indices are chosen and reconstituted mechanically on a June 30 cycle - check the rules on their Web site - and with a longer lead-time than Standard & Poor's provides. The rule-based switching process for individual stocks between the Russell 3000 Value index (RAV) and its growth counterpart (RAG) has created a trade popular among hedge funds of buying the issues going from one to another. At present, more funds are benchmarked passively to the RAV than to the RAG, which will put net buying pressure into those issues moving into RAV and net selling pressure on those moving into RAG.

Regardless of the annual reconstitution trade, the RAV has been favored strongly over the RAG since the bear market began in earnest in September 2000 (both indices started on July 26, 2000). While it may seem obvious that value would outperform growth during a bear market characterized by the hot and overvalued getting taken out and shot, this is counter to financial theory - just as was growth's dominance during 1999 and early 2000.



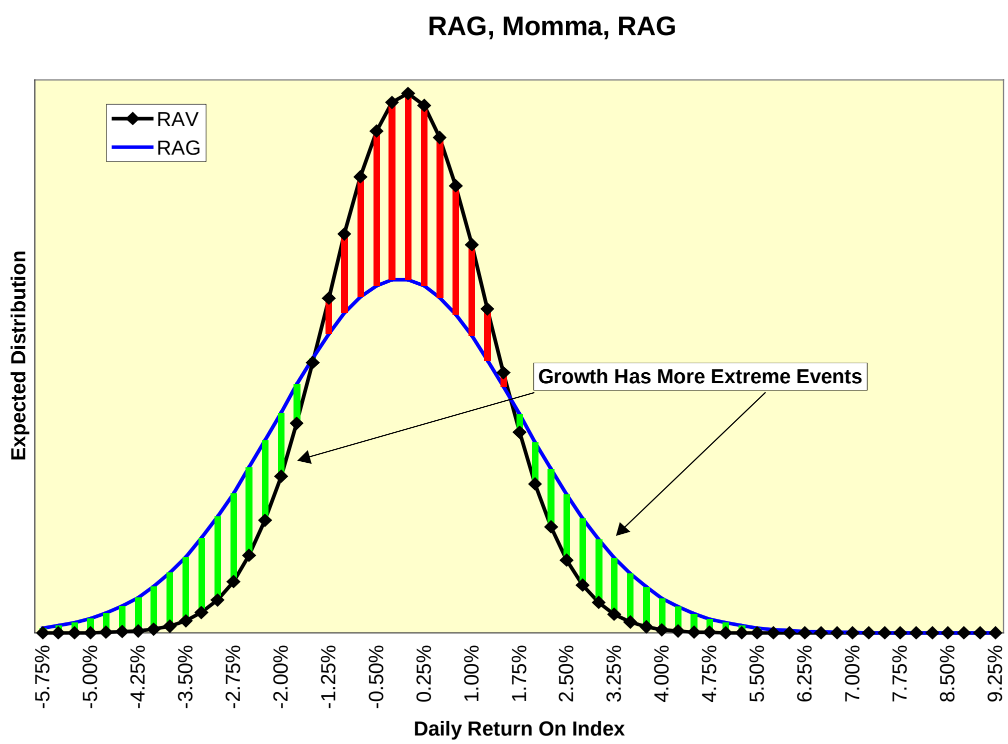
In a rising interest rate environment, we should favor higher yielding stocks whose dividends can be reinvested at those high yields at whose earnings are not imagined in some distant future. Conversely, we should expect growth to outperform in a lower rate environment when those far-off earnings are discounted at lower rates. That the observed experience since 1999 has been diametrically opposite is not a repudiation of this theory (see [my August comments]() on intermarket analysis), but rather evidence of just how respectively exuberant and despondent earnings expectations have been over this period.

The rather striking inverse relationship between the interest rates and the relative performance of RAV to RAG is but one part of a multi-factor model linking the two styles. Other factors include exchange rates and energy prices, as well as the more macroeconomic factors related to the health of specific industries, technology in particular. Given the present environment and the strongly inverse relationship between stocks and bonds of late, we should expect to see any upturn in the economy producing both a bond selloff and the RAG outperforming the RAV.



Embedded Option

The switches made between these two investing styles and the different volatilities associated therewith create an embedded option, a naturally asymmetric pattern of returns that you can exploit. If the daily returns for RAG and RAV are converted into probability distributions, the preponderance of extreme events in RAG becomes apparent.



The conversion of this natural embedded option into a trading strategy will be discussed at a later date, probably after the introduction of single stock futures on the style ETFs. Let's just say there will be plenty of room for tortoises and hares and for bulls and bears. Turkeys, alas, will have to fend for themselves.