BY ALLISON KOPICKI PHOTOGRAPHS BY JEFF JACOBSON

SOBER ADVICE FROM UNSERIOUS DRINKERS

AT THE MEETINGS OF QWAFAFEW, THE MATH NERDS OF WALL STREET TOAST ETERNAL TRUTHS—AND FLOAT SOME BRAINY INVESTMENT IDEAS

HERB BLANK HAS A BIG, CRAZY PLAN. To regain investors' faith in the stock market, the Big Four accounting firms should make a long-term investment. "They should agree to audit each others' clients, going back over the last two or three years' statements," he told me in May. "It would be a concerted effort. They'd catch some irregularities, how many I don't know. But that would be a huge step toward restoring confidence." ◆ Blank, an affable 46-year-old with a David Letterman grin, may not look like a firebrand, but as the chief executive quaffer of QWAFAFEW—the Quantitative Work Alliance for Applied Finance, Education & Wisdom—his highest duty is to keep the drinks coming and let opinions fly. "The risk inherent in the current equity market is grossly understated, and will continue to be," he wrote the membership in June, "as long as investment professionals such as ourselves are content to whistle past the graveyard."

A consultant to pension funds at QED International Associates, Blank, like most in QWAFAFEW's ranks, is a quantitative strategist—in Wall Street parlance, a quant. By schooling and temperament, quants are supposed not to be much concerned with the downward spiral of a WorldCom or any other discrete blip on the screen. (Blank says his own portfolio is in broad-market exchange-traded funds [ETFs], bond index funds, international indexes, and cash.) Unlike sell-side analysts and a majority of mutual fund managers—that is, unlike most talking heads on the financial news channels—quants don't give a whit about a new CEO at the Gap or last quarter's sales trend for Amgen. Although they can be found nowadays at every investment bank, most quants remain a breed apart. They take the long view, the macro approach, poking through reams of data, sifting the numerical evidence in search of investing's lasting truths.

Given recent market shocks, quants are also arguably the most trustworthy—the least tainted—sages making a living on Wall Street (we bow in the direction of value diehards who never bought into the bubble). Money managers with an academic bent, they aren't necessarily the closest of friends with sell-siders down the hall. "Quants aren't very good at knowing where to get the best steak dinner in town," Blank notes. "People don't spend their soft dollars on us."

TO SECTOR INVESTORS, GARNICK SUGGESTS IMAGINING THE BUBBLE NEVER HAPPENED. "WE WOULD BE BEGINNING THE CONTRACTION PERIOD OF A NORMAL BUSINESS CYCLE."

But they know where to gather to wet their whistles. At least once a month since February 1997, QWAFAFEW has been bringing the math-minded men and women of finance together to raise a glass and think out loud, presenting drafts of papers that later end up polished and published in professional and academic journals. Because they are advising institutions or running funds, their ideas can make a real difference to investors, changing the way pensions cut risk, indexes get constructed, or fund managers trade. Wall Street learns from them, and every month at QWAFAFEW they network, jawbone, and learn from each other. "At an academic conference, there are not many questions," says Wayne Daniel, the organization's programming chairman and a senior product consultant for QED. "You'll get the occasional 'Please elaborate; I don't understand.' But you rarely get anyone to ask a really devastating question...or to tell you your theory is pure bull."

As the market headed toward pure bear this year, I began attending QWAFAFEW's New York City sessions (there's a long-standing Boston chapter, too, founded by Manhattan émigré Michael Wilcox) to get quants' unvarnished—or perhaps slightly shellacked—views on the problems they see in

the markets and where investors should go next for gains.

Quants have their biases, of course. Passive vehicles—index funds and their hot offshoot, ETFs—are a frequent and natural theme for this number-driven bunch. Daniel, 64, has been preaching their virtues for years. Literally a rocket scientist, having spent his early career working for the precursor to NASA, he began in finance at Citibank in 1968. Quants were fewer back then. "Fischer Black, Harry Markowitz, Bill Sharpe—you could fit us all around one lunch table," he recalls, chuckling. "I'm the only one of that group that didn't get rich or famous." While Citibank paid for his M.B.A., says Daniel, "I discovered that the concept of moneymaking is a myth. It's stock-pickers' ego. They think they can beat the market. The numbers tell me otherwise. In an efficient market, in any given year, maybe 20 or 30 percent of money managers beat the indexes, but they're not the same ones three years in a row."

For the next 30 years, Daniel analyzed equities, derivatives, and international markets, working for many of the big investment houses. He compares the current market to the late '60s and the period from 1977 to 1982, when the Dow Jones Industrial Average couldn't break 1,000. "In both cases, the market ran way up, then fell and lay there for several years." He's expecting such sideways action now. "The excesses of the last boom have to work themselves out, and that takes time," he says. "At least another two to four years."

Perhaps that will be time enough to fix the style indexes to C. Michael Carty's satisfaction. Carty, who manages money at New York City's New Millennium Advisors, has a few beefs with the most popular growth and value indexes, run by Barra and Russell. Every January and July, Barra takes the Standard & Poor's 500 companies and divides them in two, using a single statistic, book-to-price ratio—a company's liquidation value divided by its share price. The companies with higher book-to-price ratios that together represent half the index's market value are assigned membership in the S&P 500/Barra Value Index. The other half go into its growth index. By including every S&P 500 company in the two indexes, Carty believes the results are a muddle. For example, United Technologies and General Dynamics are big players in aerospace and defense. On paper, they're barely distinguishable: They have similar 12-month earnings per share ($4.11 and $4.59, respectively), five-year projected growth rates (14 and 12 percent), and price-to-earnings ratios (16 and 18). Yet United Technologies is a Barra value index member while General Dynamics is in the growth category. What's worse, price movements can and do make the designations meaningless. In August, General Dynamics was a hair more of a value, with a book-to-price of 0.2899, than United Technologies at 0.2890.

Carty, 56, the New York chapter's treasurer and best heckler, doesn't like the Russell indexes, either. "Russell's method of attributing both a growth and a value component to a particular company doesn't make sense," he argues. "Investors can't get into just the value side or just the growth side of a company." Moreover, companies end up on both lists. Procter & Gamble holds the 12th-largest position in the iShares Russell 1000 Growth Index Fund and the 13th-largest in the iShares Russell 1000 Value Index. In all, 335 companies do double duty. The way out, he says, is multiple criteria for each index—for example, growth stocks would be defined by high readings for earnings, return on equity, operating income, earnings projections, and debt and other leverage. A vast middle range of companies would lie in neither camp.

These inadequacies have been previously noted. StreetTracks runs large-cap and small-cap ETFs based on Dow

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INDEXING CRUSADER CARTY IS WAITING FOR A BOTTOM. "IF I THINK A CERTAIN SECTOR IS GOING TO DO WELL, THEN I'LL BUY THE SELECT SECTOR SPDR FUND."

Jones's multiple-criteria growth and value models, and this summer Morningstar, which has licensed its style boxes with an eye to ETFs, elaborated its criteria, producing "value indexes that are value-ier and growth indexes that are growthier," says Blank. Carty likewise aims to get his improved indexes licensed so he can run ETFs off them. "Michael's model is even closer to getting true growth and value," Blank says. "You could think of his indexes as robot growth and robot value managers, selecting only the stocks that are investable."

In the meantime, keeping his distance from the bull market hangover, Carty is holding large cash positions in the accounts he manages. Though the lows of the summer were beginning to look enticing, in early August, as stock indexes sawed back and forth daily, he was still waiting to be "absolutely convinced" that the market had established a bottom. When that day comes, "do you buy a whole lot of little stocks or do you buy the Spider, the Qubes, the Diamond?" the index crusader asks, citing the ETFs that track the S&P 500 (SPDR), the Nasdaq-100 (QQQ), and the Dow (DIA). "If I think a certain sector is going to do well, then I'll buy the Select Sector SPDR fund. That allows me to go from a cash position in just a few trades to a 100 percent stock position." By the time you read this, Carty will probably also be invested in the new fixed-income ETFs, which he aims to use in creating balanced portfolios for his clients.

Diane Garnick, 35, global investment strategist for State Street Global Advisors, calls ETFs a perfect example of a quant-created product. "An ETF holds a finite number of stocks," she says, "and holds them in the most effective diversifying manner." Her rule of thumb for investors: Use index funds in 401(k)s or IRAs, and use ETFs for all taxable accounts. "Above all else," she says, "we favor low fees, inclusive of taxes."

Despite what he considers dire times, Herb Blank says he wouldn't wager his retirement on the S&P 500 Index ending in negative territory. "Betting against the U.S. stock market long term hasn't been a profitable activity in the past," he notes. His recommendation to investors is to get defensive assets into their portfolios. He suggests allocating to cash, real assets like real estate, gold, petroleum, and inflation-indexed bonds, even modestly profitable guaranteed investment contracts (GICs). "Two percent return may seem like trash, but it's better than negative 10 percent," he says.

Low expectations aren't what investors want to hear, but Daniel says just about every market has its bright spots. "History gives us that 20/20 hindsight. The place to be in the '60s was in the Nifty 50. In the '70s, it was hard goods. For most of the '80s, Japanese equity was the place to be. In the '90s, U.S. markets." And now Daniel sees lots of money looking for a home. He points to Federal Reserve policy. "What was their answer to Long-Term Capital Management, to the Russian bond default, to Y2K, to 9/11? Their solution was to flood the system with money. Most of it's still out there. Economics 101 says that the money has got to go somewhere."

Daniel, like Blank, sees plenty not to like. "U.S. stocks are still rich by any measure. Bonds don't look attractive with the low interest rates," he said in mid-July. Internationally, he thinks Japan is still broken and the government has yet to admit it. Russia and China are really hard places to make money historically, he adds. What about Europe? "We have Eurosclerosis," he says. "They like things the way they are and don't really want to change. So there's only plus or minus 1 percent growth." As far as bonds go, Daniel says to stick with "short-term fixed income. You don't want to be in long-duration investments in a rising interest rate world, which I foresee for the next few years."

With money flowing into real estate and gold, Daniel perceives the beginning of bubbles there, and with the cash overflow needing somewhere to go, inflation in the offing. "I know

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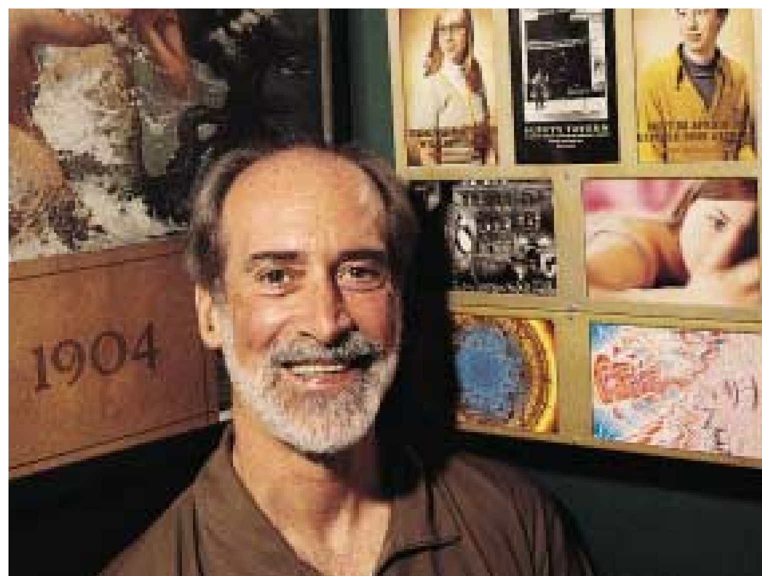

inflation is counter to the conventional wisdom," he admits, adding that he suspects the consumer price index isn't picking up cues from service expenses like car repairs. For the moment, says Daniel, "Investors' best bets are hard goods. Real estate, metals, anything you can drop on your foot. A bag of silver coins."

Wilcox, 56, a currency specialist at Alford Associates in Alford, Massachusetts, suggests looking overseas for diversification. He doesn't expect to see the high correlation between international and U.S. markets, as in the crash of 1987. "That was a worldwide phenomenon, not just a New York Stock Exchange thing," he says, "and it would surprise me [if it] stayed that way in the future. The United States has been a strong force, with the dollar strong and the economy strong, and that has helped boost other economies." But times change. "Now the world is rudderless. You will see China and India become powers in the future, but for now, they're too difficult to invest in. South Korea and Thailand are others becoming less dependent on the rest of the world, creating their own strong economies. And it may be that the United States will be left somewhat behind."

Currencies, Wilcox adds, "tend to swing drastically. With the dollar's fall, it could be the euro's turn to be overvalued. We'll see a 10 to 15 percent drop in the dollar over the next year or two. You'll have an advantage if you're in foreign stocks with the returns in local currency. If the European market and the U.S. equity markets perform the same, you would have a performance advantage by being in foreign markets and not exposed to the dollar." That means being in international funds that don't hedge currency, or an ETF like iShares MSCI EAFE Index Fund, though Wilcox knows that some studies show active management beating passive when it comes to international stocks. "The big [ETF] advantage is that you're diversifying your portfolio with very little management fees," he says.

The same ETF advantage applies to U.S. equities, Blank notes. Rather than try to pick the hot fund manager of the moment, Blank thinks you might as well put your money in a broad-market ETF like the Vanguard Total Stock Market VIPER or the iShares Russell 3000 Index Fund, because the tax advantages and low fees are too good to pass up. "Pick your poison," Blank says. "Whichever ETF you prefer. Then, if you know something of unusual value about a sector or slice of the market, you can overlay it, stay there, and forget about it for a year." It might be a boring way to invest, he adds, "but trying to get rich might be the best way to get poor."

Garnick also takes a dim view of the immediate future, suggesting that the profit recession plaguing the U.S. market will continue into 2003. "What's very important right now is that corporate accounting is consistently unpredictable," she says. "An investor cannot know what stock's balance sheet is going to blow up next." Investors should just take that unknowable out of their portfolios by sticking with index products, she believes. "In times of uncertainty, owning a broad-based portfolio gives an investor the greatest hedge."

For those investors who long to recapture their recent losses, Garnick's counsel is to suppose that the bubble never

DANIEL EXPECTS INFLATION TO BECOME A FACTOR. "INVESTORS' BEST BETS ARE HARD GOODS. REAL ESTATE, METALS, ANYTHING YOU CAN DROP ON YOUR FOOT. A BAG OF SILVER COINS."

occurred. "If we come back to mid-1995, when some argue the bubble was just starting, we would be beginning the contraction period of a normal business cycle," she notes. At State Street, operating from her global perspective, defensive positions come first. "First we determine how much debt we should be in. Then, how much do we allocate to equity? Which countries are the most promising to be in? The next step is to look at which sectors we like, then the style in that sector, and finally, size. Investors have to learn to ask, 'Should I be invested in this sector at all?'"

Quants' cool attention to modest prospects in the face of trillion-dollar market losses may not qualify as bedside manner, but when you consult a pathologist rather than a pediatrician, sangfroid comes with the territory. So does self-deprecation, fortunately. Carty, in explaining why he never completed his doctoral studies, recounts, "Well, I was reading a magazine one day and there's a photograph of a school of econometrics, and up above the school is the motto: 'Foretelling the past with ever greater precision.'"

Whether despite or because of market gloom, the quants' drinking-and-thinking club is a growth phenomenon. Having graduated from taverns (one bar owner doubted their math when it came to the tab, and Michael Wilcox ended up knocked to the floor), QWAFAFEW often convenes in the penthouse conference rooms of the Metropolitan Hotel at Lexington Avenue and 51st Street. The informal setting, with a full bar and plenty of cocktail wieners, draws crowds of 40 to 50. At $30 a head, the meetings have become so successful, Blank says, "I'm the president of a nonprofit that makes money, and I work for a for-profit that's in debt."

Senior writer Allison Kopicki's feature on exchange-traded funds appeared in the April 2002 issue. For a comprehensive list of ETFs, go to www.bloomberg.com/personal.