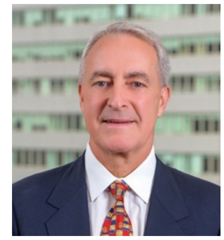

Thoughts for Investors

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"If history repeats itself, and the unexpected always happens, how incapable must Man be of learning from experience."

– George Bernard Shaw

SO WHAT DO WE DO NOW?

The economy is on an upswing and the stock market seems to have bottomed out. In fact, we are told that stocks are expensive. Did we miss when they were cheap? So what do we do now?

In this newsletter, I would like to answer that question in two steps. First, I would like to address what investors should consider not doing, followed by what to do now.

Everyone who took a Physics class was taught that "an object in motion tends to remain in motion unless acted upon by an equal and opposing force." If you believe that a pickup in the economy or changes to the tax law are enough of an "equal and opposing force" to stop the slide of the stock market then the first thing investors should not do is position their entire portfolio for a repeat of the big market decline similar to what we've just been through. This includes "shorting" stocks. Some hedge funds turned in good performance numbers during the bear market by shorting stocks or making other negative bets. Those performances in turn attracted many new investors and many copycat hedge funds were started. Unfortunately, many funds didn't change course when the market turned up in 2003. And if they still have not changed course, 2004 could also be a bad year for them. The stock market historically rises three out of four years. Therefore, portfolios heavily dependent on a declining market to make money are swimming against the current. The time for widespread shorting of stocks was 1999 not 2002. Yet many investors who are now shorting stocks have arrived late for the party. This is the "past performance" phenomenon whereby people invest based upon what has happened in the past because that feels more comfortable than the unknown future. How confident would you have been in someone who was going against conventional wisdom and was bullish at the beginning of 2003?

Second, an investor should avoid the "belt and suspenders" phenomenon. If I wear both, then my pants will never fall down. It's very profitable for Wall Street these days (and therefore costly for investors) to layer on their portfolios all kinds of "protection" against another market decline. Unfortunately, buying "protection" now is similar to people who increase their insurance coverage after something happens. "Protection" includes all kinds of hedging strategies too numerous to detail. The "cost" comes in several forms, the least of which is the trading costs. More onerous costs include buying insurance against the wrong disaster and/or for the wrong period of time. All these costs end up eating into the return if no disaster happens, plus you must continue paying the premiums. The rule is that the more you reduce your risk, the more you reduce your potential for return. It's not possible to get the return of stocks with the risk profile of US Treasury bonds.

"Far more money has been lost by investors preparing for corrections or trying to anticipate corrections than has been lost in corrections themselves."

– Peter Lynch

Third, guard against losing your investment nerve. Some phrases heard after the bear market were “I learned my lesson, no more stocks” or “no more high PE stocks” or “from now on I’ll only invest in five-star funds or funds that don’t have internet related stocks.” During the bear market there were very few places in the stock market to hide. If you have enough capital to meet your goals, then having only a small percentage of it in stocks is OK. However, beware of changing your investment philosophy and strategy without proper reflection and planning. You may be running right into a bear market in a different asset class.

“The time to reflect on your investing methods is when you are most successful, not when you are making the most mistakes”

– Sir John Templeton

SO WHAT DO WE DO NOW?

First and foremost, the thing to do now is to invest consistently—through both bull and bear markets. Benjamin Graham called “dollar cost averaging” suitable for the “defensive investor.” In the above table, that is Investor B. No one knows how long their investment career will be. It could be very long as with a young investor or very short as with an older investor. The best case is to invest early and keep investing and the worst case is to have your investment career cut short before your portfolio has grown enough to support you in retirement. Dollar cost averaging through all phases of a stock market cycle instills patience, helps remove emotion from the process, and prevents pyramiding. In addition, with enough time, Investor B’s return will even surpass that of Investor A.

Second, be realistic! The average bear market lasts one to two years, not forever. This is because, humans who make up the market are always thinking, inventing, challenging and moving forward, even if it seems imperceptible at times. Even if you personally cannot see much improvement, the next Bill Gates or Louis Pasteur is out there. Be defensive when times look great. Be offensive when times seem terrible.

“Your success in investing will depend in part on your character and guts, and in part on your ability to realize at the height of ebullience and the depth of despair alike, that this too shall pass.”

– John Bogle

Finally, be flexible and opportunistic. There are values and opportunities for growth and profit created every day, in all kinds of industries, by all kinds of people looking to improve their life and that of their families. They are the ones, not financial commentators, who know their businesses intimately and what these businesses can achieve.

In summary, there is no easy answer to what we should do now. Investing is not a mechanical process although there are some mechanical steps to investing. Investing is, was, and will always be, a complex combination of science and art built on flexibility, realism, and patience.

“Knowledge is the Treasure, but Judgment the Treasurer of a Wise Man.”

– William Penn

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If you would like to discuss the topic of this newsletter, or our team's approach to investing, please feel free to contact us by email at al.boris@alexbrown.com.

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