



Friday, September 4, 2009

Porsche 911 or Smart Car?

The week's economic data continues to point to recovery, but investors worry whether it will be strong enough to support the stock rally since March 9th. The S&P fell 2.6% this week as of yesterday's close. September is historically the worst month for the stock market. In fact as Ed Yardeni notes, since 1926, September is the only month with a negative average return. Investors lose an average of 1% during September compared to a 1% return for the other 11 months. So the market may be in a holding pattern for a while. This is a good time to forego analysis of the various economic and market wiggles to take a broader and longer perspective on investing.

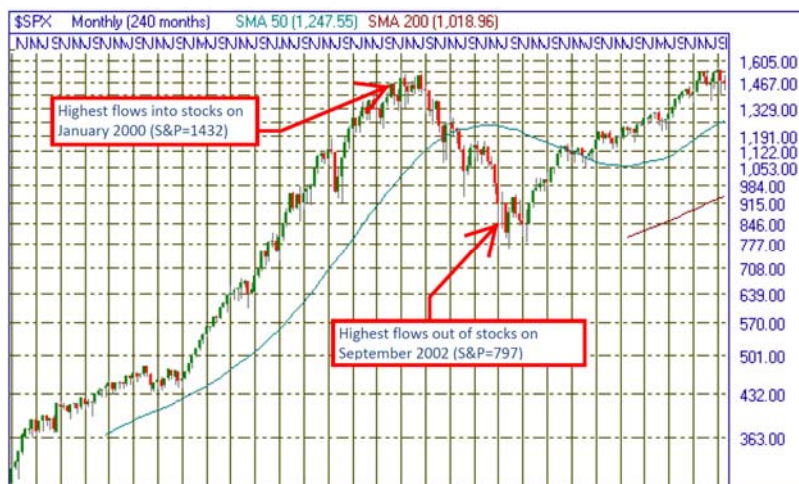
The global capital market exists to link investors to businesses and governments in a perpetual exchange of capital. Money is invested either into equity (ownership) or loans for periods longer than a year. Opportunities provided by the capital markets are perceived in as many ways as there are individual human beings to perceive them; ranging from pure entertainment for some to all kinds of logical and contra-logical modeling schemes based on the premise that patterns repeat in predictive patterns (technical analysis), or on fundamental values which lend themselves to predictive success (fundamental analysis), or finally to the idea that it is impossible over long periods to out-smart the capital markets sufficiently to gain better returns than can be gleaned through a passive program designed to efficiently capture the full extent of returns the capital markets offer (indexing).

The last four years have provided an excellent period to study investors' behavior. During this time we witnessed both extremes of optimism and pessimism. We experienced several bubbles of epic proportion. The housing bubble, funded with virtually free money from government stimulus combined with the generally held assumption that houses only appreciate in value, produced unprecedented trading in houses and other real estate for huge short-term gains. Commodities, particularly oil and copper saw huge run-ups in their prices driven by demand in part, but largely at times by speculators and day-traders. And the one that did us in (for a while anyway) was the notion that combining many mortgages (implied diversification) in a pretty AAA wrappers (implied quality) and securitizing them for marketability (implied liquidity) would allow banks to stretch to new heights their profitability (and their leveragability). But the limits of nature are invariably reached and bubbles burst.

The unfortunate result is that real lives are significantly affected. Economies are wrecked, capital dries up, survival plans replace plans of innovation, expansion, and improvement, jobs are lost, and nest eggs are dramatically altered or ruined. Another major casualty is that many investors surrender and leave the capital markets altogether and for good.

When investors are not focused on long-term goals and do not fundamentally believe that the capital markets are capable of getting them to their goals, when they do not have a plan that addresses the unpredictability of market risk certain to impact that plan, they are apt to react emotionally and to make mistakes along their way. Studies show that individuals receive far

lower returns over long periods than those of the capital markets or of managed funds because they base their investment choices on their short-term emotional outlook, positive or negative. A study by Benartzi and Thaler in 2006 showed that retirement plan inflows by a large margin peaked near of the height of the technology bubble in January of 2000. Those emotionally convinced investors rushed into the market at its height, just before falling 44%. And yes, true to form, the largest outflows of investor dollars occurred just before the rally took the market even higher the next time. While the study ends with 2002, it's a safe bet that the next big inflow of investor funds occurred at the far right of our chart below, the next peak.



Despite all of Wall Street's marketing and promises, the capital markets remain what they are – unpredictable and unbeatable. The investor needs less hype and more truth regarding investing. Unfortunately, investors play right into the hands of marketers at the expense of maximizing their more important long-term goals. Our instinctive desire for short-term returns and our Madison Avenue up-bringing compel us to choose the Porsche 911 model over the Smart Car model in our investment approach. We are attracted to the shiny brochures and the fast track records over the practical, safe, and low cost approach almost every time. But consider your portfolio for what it really is – a vehicle to get you to your life's goals. Take another look at the car analogy.

Imagine strapping yourself into that shiny new Porsche 911. Now imagine, what is the very first thing you think about? Be honest. My guess is that there is not one ounce of practicality in your thinking. In fact, your thoughts likely don't include your destination at all. If they do, you are likely wishing that your destination is further away than it is. It's the journey after all, right?

Come back to reality with me now and let's consider your portfolio for what it really is – a vehicle to get you somewhere, retirement for most. If it is really just a vehicle then why would you choose anything other than the most practical, safe, low-cost approach? Why would you risk more than was necessary to get to a destination knowing that the road ahead was fraught with unexpected curves, obstacles, and the unpredictable moves by drivers with whom you share the road? As a driver or an investor are you intelligently focused on your ultimate destination or goal?

Are you trying to find the very best mutual fund out there or the hottest investment managers? Are you really sure, sure enough to bet your retirement on the colorful historical charts and manager bios they present? We actually believe as truth the statement that the SEC requires on all these publications that “Past performance is no guarantee of future results.”

Is it possible for managers to beat the market? Yes, for a time. They do so by taking risks greater than those of the capital markets themselves, by concentrating your assets in subsets of the capital markets they as managers believe will outperform the general market. Recent studies proclaim their success as luck. Is that really how you want to invest your retirement?

As we look back again to the last few years as example of investor behavior let’s ask who predicted the full impact of the financial melt-down? Few people, right? One New York University Professor Nouriel Roubini rather accurately predicted the collapse. To him go many accolades and kudos. But how has he done lately? Well, he missed the 50% recovery by staying on the sidelines.

Capital markets are naturally volatile, sometimes more than others. They are capable of rising and falling as much as 50% in a relatively short period of time. An ongoing Lipper study shows that as much as 90% of the stock market’s return is explained by 10% of its trading days. What that means is that if you are out of the market for any reason; be it fear on your part, fear on your managers’ part, or that your managers “think cash is the best place to be for now,” then you face incredibly high odds that you will miss returns, making it likely that you will underperform the broad market’s return. Who can guess ten times out of ten when is the right time to be in the market? Why take the chance or extra risk when the capital market’s return is enough to get you to your goals?

We believe strongly that a diversified, low-cost, tax efficient portfolio designed to efficiently maximize the potential implicit in capital markets is the very best option for investors who are trying to reach important life goals. Even more important is having a plan that reflects one’s financial goals, priorities, and cash flows and is continually stress-testing it against certain market risk which will occur at unknowable times along the way. We call it Wealthcare or the “Smart Car.”