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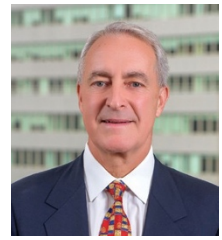
Thoughts for Investors



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Prudence

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"Genius always gives its best at first; prudence, at last"

– Seneca

According to dictionary.com, prudence is defined as caution with regard to practical matters; reward for one's own interests; provident care in the management of resources; economy; frugality. If ever there was a time to be financially prudent, now is that time. Unfortunately, the definition doesn't tell us how!

Many investors think they are acting prudently when in fact they may be acting imprudently by mistake. The reason is their belief in the "wisdom of the crowd". Years ago, many people were happy with their house until they saw people buying grander ones. Watching others, they became convinced that buying a bigger house was actually a prudent investment, regardless of whether they needed or could afford it. How times have changed. Today the opposite is considered prudent. I would argue that while prudent investments may change, prudent investment practices change very little. In this newsletter I will offer three prudent investment practices. I will also explain why doing what the crowd believes is imprudent may, in the long run, be the most prudent course of action.

"Never follow the crowd."

– Bernard Baruch, advisor to presidents

Prudent Investment Practice #1: After you have identified your needs, include in the portfolio the least risky investments that have the potential to meet those needs given the size of your assets. Do this with forethought though without emotion. For example, if you have $1Billion in assets and you need $1000 per month, a US Treasury money market fund yielding near 0% may get the job done. If, however, you need $1000 per month and you have $100,000 in assets, no amount of money market holdings will get the job done, despite your desire for safety in these times. Caution: make sure you differentiate between needs and wants.

Unfortunately, many investors are not satisfied with a portfolio that simply achieves their objectives. If there is more return to be had, and they see someone else earning some, they want it as well. This is the "danger of comparison" and I have written about this issue previously. Often investors can not accurately assess the added risk incurred to achieve the increased return. For example, look at today's fascination with gold. Admittedly, gold has had a pretty good run. Yet it has no earnings and pays no dividends. Since it has no earnings, it has no PE ratio (price to earnings) and therefore it is impossible to tell if it is cheap or expensive. While oil gets consumed, gold does not. Unless it gets lost, it can forever be melted down and reformed into something else. Its recent appreciation is based on fear and investors belief that its' past performance will continue into the future. Likewise with bond funds; many investors don't truly understand the risks. Yet the "crowd" is relentlessly pouring new money into bond and junk bond funds despite record low interest rates and the potential for future inflation. The justification is their past performance and the perceived prudence of bonds versus the perceived imprudence of stocks during this period of economic gloom.

"A prudent man procures in summer the sleigh and in winter the wagon."

Prudent Investment Practice #2: Studying history is important; and the most important investment history lesson is that “past performance is no guarantee of future results”. Knowing the past performance of an investment has merit, yet in reality, future performance is what really matters most. Colorful graphs, pie charts, alphas and betas and lengthy parsing of what’s behind us only distracts from the hard work of understanding the obstacles and opportunities in front of us. A preoccupation with “Asset allocation”, which is based on “past performance”, is akin to driving by looking out the rear window. It is gratifying to see what you didn’t hit but don’t spend too much time doing that. Prudent investing depends upon identifying investments that will perform going forward, and that is where your time should be spent.

Prudent Investment Practice #3: Macro gets more attention from investors yet micro is more important. Macro is the “big picture” and investors yearn to know the “big picture”. The “big picture” is easier to grasp and for this reason the media spends most of its time discussing macro trends. Macro trends can be said to have a binary outcome - interest rates either rise or fall, the economy is either expanding or recessing, unemployment is either going up or going down, take your pick. Investors often look to the crowd (or media pundits) for the prudent choice of position. The great investor John Templeton said he wouldn’t invest based on macro forecasts of interest rates, the business cycle, or inflation. He believed information about these factors was usually widely dispersed, incorrect, irresistible, and reflected what the crowd was thinking or doing.

"Big picture" or macro investing suffers from two shortcomings. First, it is easier to believe that any factor will simply continue to move in the same direction it is already moving. House prices are going further down. Unemployment is going further up. The second shortcoming is that the more outrageous the “big picture” prediction, the better your chance of getting on TV to talk about it. The financial media often drives the crowd toward either euphoria or pessimism because that’s what grabs investors interest.

Micro, on the other hand, can be loosely defined as studying individual companies. It is much more difficult to assess all the factors that combine to determine the success of a company. It is even more difficult to do that for a portfolio of many companies. Consequently, many investors would rather let a position on the “big picture” determine their actions. If a “double-dip recession” is predicted then no stock can be good. I disagree. Just look at the success of Apple or Amazon during this current economic gloom as verification that “it is a market of stocks, not a stock market”. When stocks seem to all go up at the same time, i.e. 1999, it is time to consider selling some of them. When they all seem to go down at the same time, i.e. 2009, it is time to consider buying some of them. When clients ask how the (stock) market is doing I usually reply that I don’t care – I only care how the stocks in their portfolio are doing. That’s the micro picture.

“Everyone goes astray, but the least imprudent are they who repent the soonest.”

– Voltaire

In summary, these uncertain times make investors crave comfort. “Doing what everyone else is doing” provides that comfort and seems the “prudent” thing to do. I would argue it is actually imprudent and backward looking to act that way. This very morning, someone got up, looked in the mirror, and said, “Move over Bill Gates, it’s my turn”. The next Microsoft or Apple or Starbucks is out there. The prudent thing to do is to start looking now.

“We are what we repeatedly do. Excellence, then, is not an act, but a habit.”

– Aristotle

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Hear the Other Side

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