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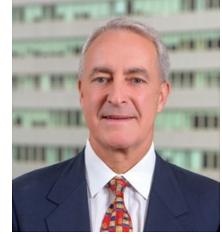

Thoughts for Investors

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"The fault lies not in the stars"

– Al Boris

Since last winter there has been a dramatic turnaround in the US stock market. The popular averages such as the S&P 500 and the NADSAQ are up 35% and 58% respectively since their lows in March 2003. Some individual stocks have experienced even more dramatic turnarounds. For example, Intel is up over 100% since it's low in February. Is the next bubble forming? Are these price advances warranted by the coming economic turnaround? Or is the economic turnaround already priced into stocks? How will the stock market react?

What can we learn from both the bull and bear markets we have been through over the last several years? Could investor strategy be the cause of these fluctuations? Assuming fluctuation is here to stay, what can investors do about it?

In this newsletter I would like to examine the two methodologies for capitalizing on fluctuations, Pricing and Timing. Pricing allows the investor to control the process, while timing does not (as you will see). Since neither, of course, can guarantee the outcome, I will try to make the case that Pricing is the less risky methodology for most investors and Timing is the siren's song.

<u>The Fallacy of The Efficient Market Theory</u>

Efficient Market theorists claim that the market efficiently values all available information when pricing a stock. Therefore, they say a stock's price is its value and there is no "opportunity" for an investor to find and profit from an "inefficiently" priced stock. The logical extension has become that investors should use index funds (notwithstanding other shortcomings of that technique) so they can receive whatever return the market is giving. Some call this the "auto-pilot" approach. Unfortunately many investors crashed while on autopilot when the S&P 500 index declined by 50% over the last three years. Only now have they realized that autopilot is only good when conditions are good.

Some say that index investing has hurt the economy. For example, money invested in the S&P 500 index years ago bought Enron stock, an index component. Enron management used the increasing value of their stock to finance what we now know were questionable investments. This hurt investors, legitimate competitors, and the economy in general.

Another great shortcoming of indexing and the Efficient Market Theory is that it was not able to help investors capitalize on the dramatic rebound in the prices of select stocks over the last few months. This is because both methods lull investors into thinking that good returns on their portfolios are the result of all stocks uniformly going up. Even the concept of mutual funds contributes to this problem. A 10% return is not achieved because every stock went up 10%. Rather, one stock rose while another fell, and many others did nothing. That reality is masked when investors believe the market is efficient or that indexing captures the overall rise in the market. Intel's 100% rise year-to-date is certainly different than Merck's –30% year to date return or the S&P 500 index's 35% year to date return.

In a variation on the old light bulb joke, long-time successful money manager Marty Whitman asked: "How many efficient market theorists does it take to change a light bulb? None. The market takes care of it."

As Benjamin Graham paraphrased a long time ago, “the fault, dear investors, is not in our stars – and not in our stocks – but in ourselves.” The market is not efficient and indexing (or any other auto-pilot approach) doesn’t work because investors are human. In a past newsletter I spoke about the effect “investor emotion” has on investment success. Now it’s time to look at "price fluctuation" and discuss how to use that to your advantage.

Stock Price Fluctuation

Stock price fluctuations are inevitable. Any investor not prepared for some level of fluctuation when owning a stock should not own stocks. Fluctuations can be caused by macro events such as war, interest rate changes, elections, even the weather. They can also be caused by micro events that happen on a company level. Fluctuations at the level of the overall market are usually divided into “bear” or “bad” markets or “bull” or “good” markets. These terms, however, are as nebulous as describing stocks as “growth” or "value”. Not one of these terms has ever been accurately defined. Let it suffice to say that the stock market and its individual components will always fluctuate. The goal is to take advantage of these fluctuations. Graham said that this can be done either by Timing or Pricing stock purchases.

Timing – The Sucker’s Bet

Timing refers to using forecasts or predictions to anticipate the movement of the market or individual stocks. Where are interest rates headed? How will the economy perform? Are oil prices going up or down? And how will these affect any company individually?

In theory, the process of Asset Allocation is supposed to dampen the negative effects of market and stock price fluctuations on a portfolio caused by erroneous predictions. Of course, it works both ways – dampening the upside as well.

Before it was called Asset Allocation, and the myriad of asset classes were invented, people invested in stocks or bonds and used cash as a holding tank. Today we have large-cap growth, small-cap value, and mid-cap blend to name a few. To prevent the mediocrity that comes from over diversification, asset allocators must still ask investors for their outlook (read prediction or forecast) and then tilt the portfolio in that direction. Unfortunately, tilting the wrong way leads to underperformance, unhappiness, and firing the consultant.

The essence of Timing is buying in low markets and selling in high markets. Identifying these times, however, is only possible for most investors in retrospect. Fortunately, John Templeton has given us a tip on how to do this. He said, “to buy when others are despondently selling and to sell when others are avidly buying requires the greatest fortitude and pays the greatest ultimate rewards.” Unfortunately, the hard part is getting the courage to swim against the current.

Most investors recognize their limitations in economic forecasting. Therefore they turn to the “experts” and the media, whose forecasts they believe are more dependable than their own. Asked about the qualities a politician required, yet he could have easily been speaking about these "forecasters", Winston Churchill once replied, "The ability to foretell what is going to happen tomorrow, next week, next month, and next year. And to have the ability afterwards to explain why it didn't." Sarano Kelley also weighs in when he says, “the first time you hear something it's news, every time after that it's entertainment.” It’s not until long after it ceases to be news that investors start paying attention. Investors continue to pay attention because they are constantly told that they have to form an opinion. How often do you hear an asset allocator ask an investor their opinion about the direction of interest rates so they can tilt the portfolio accordingly? Investors continue to buy as the predictions and forecasts become more entertaining. The market then reacts by going higher and higher. Even at what is eventually identified as the market peak some investors won’t sell because it all sounds so promising – or they just don’t want to pay taxes. Eventually the market is low again, investors get frustrated, and some sell. Even those who don’t, sell are too afraid of the grim forecasts to buy at the low. Again Templeton's insight is right on the mark. "Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria." My conclusion is that investors who currently hold $2.1 trillion in money market funds earning less than 1% per year will probably not get comfortable to invest in stocks until the forecasts look good, the stock market is

entertainment again, and the market is approaching a new peak. I am becoming convinced that some investors, professional or novice, are incapable of buying low and selling high and are therefore are incapable of using Timing as a tool to capitalize on fluctuations. Those that continue to try end up, as Graham said, “a speculator with a speculator’s financial results.” This includes index investors who tend to stop their purchases at the market lows and resume them, with everyone else, at the highs.

Why are investors so attracted to timing? Graham explained it very eloquently. He concludes that investment timers are speculators and speculators want to make their profits in a hurry. Many investors gauge investment prowess by how quickly a stock goes up after they buy it. It just doesn't seem to take much talent to buy a stock that doesn't start to move for a year or more. College tuitions, looming retirements, it all comes upon us so fast. We need to grow our money fast. And if we are the type of investor that only plants a few seeds, (or worse does so in the summer instead of the spring) they not only need to grow in a hurry, they also need to produce an abundant yield. High consumer spending, low savings rates, every-man-for-themselves, it's not just the current state of affairs with mutual funds that is a problem.

Pricing

If Timing doesn’t work then Pricing is the only other option. Investing based on Pricing simply means buying a stock at the right price. What is the right price? It's any price an investor deems to be a bargain for that particular stock. There is no universal system for identifying a bargain. $20,000 for an old Chevy may not be a bargain yet that amount clearly is for a new Mercedes. Likewise, for trying to define a bargain price for a “growth” or a “value” stock. This is because, as Warren Buffett explained, there is no distinction between growth or value stocks. “Growth”, he said, “is simply a component – usually a plus sometimes and a minus – in the value equation.” Many investment masters have summed it up by saying that you are only ever buying "earnings" (or their potential) or "assets." Therefore, how much you value these "earnings" or "assets" will determine whether or not it is a bargain. Graham states that, if you have a long-time horizon, a less ambitious approach to investing is to simply make sure you don’t pay too much. In a women’s magazine article years ago, he advised consumers to buy their stocks as they buy their groceries, not as they bought their perfume.”

Another important aspect of Pricing can be described as Re-pricing. All stocks, because of market fluctuations, are subject to Re-pricing. However, it’s only when they are re-priced down that investors worry. Some investors who, by mistake and in retrospect, believe they paid too much for a stock, will refuse to consider additional purchases. This phenomenon is based on the belief that the new lower price must reflect the stock’s true value. At this point an investor can make one of three decisions. The first and most popular is to revert back to a timing discipline and sell because of dire predictions. The second approach is to review the original reason for buying and actively choose to do nothing and/or sell because you believe the new price is not a bargain. The last approach is to review your reasons for buying originally. Then if you are satisfied that it was a bargain, buy more at the re-priced level. Today, there are many stocks that in retrospect look like their prices of nine months ago were bargains.

Summary

So yet again the market is rising and along with it the riskiness of stocks. No one knows if we are near another peak or actually not far off the bottom. We can try to Time the market by paying attention to forecasts and predictions, or we can pay the right price. If we pay the right price most of our purchases will eventually work out. This is because "earnings" or "assets" usually don't stay below their true worth forever. Mr. Buffett once talked about the difference between buying a company and buying a stock. He said that you couldn't very often buy a company at a real bargain price because the seller has an intimate knowledge of its value. However, you can often buy a stock at a bargain price because so much of a stock's price is determined by investor's emotions.

Which method should you choose, Timing or Pricing? Hopefully I've given some insight. Hopefully, you will decide that Pricing offers the greatest chance for long-term success. As for Timing, well, you’ll just have to wait for the next bear market.

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