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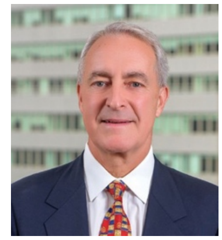

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Thoughts for Investors

Winter Newsletter to Clients

FEBRUARY 2008

"When you are going through hell keep going"

– Winston Churchill

FEAR

2007 was certainly a volatile year, with investor emotions swinging frequently from happiness to fear. For example, from February to March the Dow Jones Industrial Average (DJII) dropped nearly 6%; then from March to July it rose nearly 16%; then from July to August it dropped nearly 11%; then from August to October it rose nearly 13%; then from October to November it dropped nearly 10%; then from November to December it rose over 8%; then from December to year end it dropped nearly 4%*. (*These figures include peak to trough intraday prices within the months mentioned.) That trend in volatility is continuing in 2008. Each move seems to hinge on investors interpretation of some event; from high oil prices to low oil refining capacity; from rising house foreclosures to falling house prices; from increasing inflation to a decreasing dollar. Even the upcoming presidential elections seem to be affecting the stock market.

If you are under 65 years old (and expect to be alive and spending money at 85 or older) then you have a long investment horizon. If you are currently enjoying retirement, and are not yet well over 85, then you too may have a long investment horizon. In either case, this volatility is not easily ignored. (Note: last year, Hallmark Cards sold 85,000 "Happy 100th Birthday" cards!) Where is the stock market headed? Is it time for investors to rearrange their asset allocations based on another economic statistic? Are we at the beginning or the end of a bull market or of a bear market?

In this newsletter, I will give you John Templeton's easy to understand, no arithmetic necessary, tool to help investors gauge where we are in the cycle of the stock market and whether there is danger or opportunity ahead.

"Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria."

– John Templeton

That's it. As promised, there is no arithmetic. Rather, Templeton's "calculation" of where we are in the cycle of the stock market is based on what I believe is the single driver of stock prices – EMOTION. While the movement of the stock market is, more importantly, the collective movements of all the individual stocks, for purposes of this discussion I will concentrate solely on how emotions move the stock market as a whole.

Some have argued that while emotion moves the stock market in the short run, the fundamentals (of the economy, government policy, etc.) move its price in the long run. I believe, however, that emotion, as described in Templeton's quote, is the only driver of the stock market (and individual stock prices as well). I believe that investors, indeed all humans, ultimately act based on the present – what they see, hear, or feel now. If present information about the economy is positive, then everyone is happy, they all buy together in a herd (which provides positive emotional reinforcement) and the stock market rises. A rising market begets further happiness which begets further buying and further market increases. This is the phenomenon of "momentum". Of course, few investors see this as dangerous. To them the continued rise of the stock market is justified by the optimistic view of economic fundamentals. In the extreme, optimism turns into euphoria and the stock market rises far above its value.

The process works much the same way in the opposite direction. Emotional investors, when afraid and/or anxious, adopt a "glass half empty" mentality. Skepticism ultimately turns into pessimism when negative emotion and the herd mentality result in a stampede of selling. In both positive and negative scenarios, information which does not support the current emotion is often ignored or dismissed.

Rather than attempting to parse all the economic news and data, investors can ask, "what is the prevailing emotion?" If emotions are euphoric, then the stock market is more likely near the beginning of a bear market. If the prevailing mood is pessimistic, then the market is likely close to the end of a bear market. It is also important to remember that the stock market can remain in one phase for an indeterminable time or vacillate, so patience is also an important investor trait.

In summary, parsing economic factors for a clue to the direction of the stock market is fascinating. Yet the high level of volatility in the stock market today suggests that no one knows how to do that. Understanding the role that emotions (pessimism, skepticism, optimism, and euphoria) play in the movement of the stock market is step one. Step two is to observe one's own emotions and the emotions of other investors. This will tip you off to the likely stage of the stock market cycle. (Note: most investors will be experiencing the same emotions). The last step is getting control of one's emotions and harnessing the power of all the volatility created by emotional investors. This is the most difficult step. Shelby Davis, the very successful founder of the Davis mutual funds once said, "I made most of my money in bear markets, I just didn't realize it at the time." He meant that while investing in stocks during a bear market was scary, in the long run it turned out to be financially rewarding. Below is a wonderful passage from Dr. Martin Luther King's book of sermons: Strength to Love. In it he describes normal fear and abnormal fear. While it is not often easy to tell the difference, success depends upon one trying.

"Normal fear protects us; abnormal fear paralyzes us. Normal fear motivates us to improve our individual and collective welfare; abnormal fear constantly poisons and distorts our inner lives. Our problem is not to be rid of fear but, rather to harness and master it. But we must remember that abnormal fears are emotionally ruinous and psychologically destructive. Sigmund Freud spoke of a person who was quite properly afraid of snakes in the heart of the African jungle and of another person who neurotically feared that snakes were under the carpet in his city apartment. Most of our acquired fears are snakes under the carpet."

-Dr. Martin Luther King

"Fear makes the wolf bigger than he is"

– German Proverb

AUDI PARTEM ALTERAM

Hear the Other Side

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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.

Thoughts for Investors is a quarterly newsletter written for clients since 1997 by this author. The purpose is two-fold. First, it is meant to help explain the investment philosophy that guides the author's approach to portfolio management. Second, it is meant to remind readers of important behavioral skills that the author believes are necessary to help them become successful investors. The author welcomes comments and criticisms, especially if they can be shared for the betterment of all investors. Quotation is permitted with full attribution.

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