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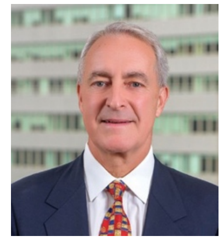
Thoughts for Investors



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Buy Something – Sell Something – Do Something! DECEMBER 2007

"Smooth seas do not a skilled mariner make."

– English Proverb

I am sometimes asked why there is little "turnover,"* i.e., buying and selling, in the portfolios I manage, even during volatile times such as those we are currently experiencing. In this newsletter I will address why lower turnover is better and why that does not mean "nothing is happening."

This past summer, my family and I had the pleasure of being taken sailing on a beautiful old wooden sailboat in Maine. It was a lovely, sunny August afternoon with enough breeze to keep us moving – but not enough to test a captain's skills. We were anxious to get going, so I thought I would volunteer to raise the sails. However, after fumbling with the large sail sheets billowing in my face and the tangle of lines, I decided to leave the job to the captain. Within minutes the sails were up, the lines were cleated, the captain settled in at the tiller, and we were on our way. (Note: I may not know how to sail, but I do know the jargon!) From that point on the captain's job seemed to consist of nothing more strenuous than looking over the bow and keeping his hand on the tiller. The wind was at our backs, and it pushed us along nicely.

After watching him for awhile, I decided that I could easily do the captain's job, so I asked if I could "take the helm." For the first half hour things went smoothly, so smoothly that he felt confident enough to go below deck. I was now completely in charge, convinced I was a pretty good sailor. This is despite the fact that I'd only ever "captained" a Sunfish.

No sooner had he disappeared below deck than I realized the helm wasn't responding and we needed to tack. Searching deep into my sailing expertise, I tried everything but couldn't get the boat to turn, and we were getting dangerously close to shallow water. So I did what any person who is "over his head" would do: I yelled to the captain for help. The boat won't turn I told him with a mix of "I'm not nervous" and "there is something wrong with the boat." He looked around, silently assessing the situation. In a matter of seconds he reached for a pole lying on the deck, leaned over the stern, put the pole in the water and yanked it vigorously a few times. Then he took it out of the water and returned it to its resting spot. "You were dragging a lobster pot," he chuckled, as he retook command and tacked the boat away from peril. So the story has a happy ending. I returned to my position as passenger, and we proceeded to have a wonderful sail that sunny afternoon.

"Never confuse motion with action."

– Benjamin Franklin

There are several similarities between this experience and that of the relationship between a portfolio manager (the captain of your portfolio) and his client (the passenger). The first is that when the boat is sailing along smoothly, it doesn't mean the captain is "doing nothing." Our captain was simultaneously monitoring the wind, the waves, our position, and as I found out, the millions of lobster pots I saw but thought were unimportant obstacles. Likewise, a good portfolio manager is constantly monitoring his holdings and their relationship to many economic, political, competitive, regulatory, liquidity, and emotional factors. Heightened activity, rather than being a sign that "work" is being done, may be a sign of uncertainty, inexperience, emotion, lack of conviction, or just plain mistakes on the part of the portfolio manager. Also, more activity in a portfolio can potentially lead to more short-term vs. long-term gains and, therefore, more taxes paid. Worst of all, more activity can simply be a way for portfolio managers (or financial planners) to justify their existence. Inexperienced investors (as well as inexperienced portfolio managers), like inexperienced sailors, often feel the need to be constantly "steering" or "doing something."

The longer the seas and the markets remain calm, the more likely it is that investors come to believe they can captain the ship themselves. This belief is reinforced by the fact that, for short periods of time, they sometimes can! After 15 minutes or so of watching our captain seemingly doing nothing, I became convinced I could do it myself. Of course, had the seas been rough I would never have come to that conclusion. But everything was calm and I had overestimated my abilities as a sailor. Whether the "investment" seas are rough or calm, inexperienced investors can (and often do) get into trouble. Problems arise, not necessarily because they make obvious mistakes, but rather because they lack the powers of observation and judgment that experience brings.

Potential problems are always present. Experience is necessary to separate real problems from "noise." More often than not, investors will act upon the false signs of a bear market by selling their portfolio; yet ignore the signs of an impending bull market by sitting on the sidelines until they are more "confident." The result is the proverbial buying high and selling low – a sure way to do permanent harm to a portfolio. One more point to consider. Oftentimes there are multiple passengers on the ship of your portfolio. So doing harm to a portfolio can affect more than just you.

The moral of this story is that you may believe the captain of your portfolio is getting paid to do nothing because you don't see a lot of "activity" on his part. Chances are if he is good, he is actually alert to opportunities, observant of signs of danger, and ready to act if necessary in a measured way – careful not to tip the boat, crash it onto the rocks or give his passengers too rough a ride.

"Patience is also a form of action."

– Auguste Rodin

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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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