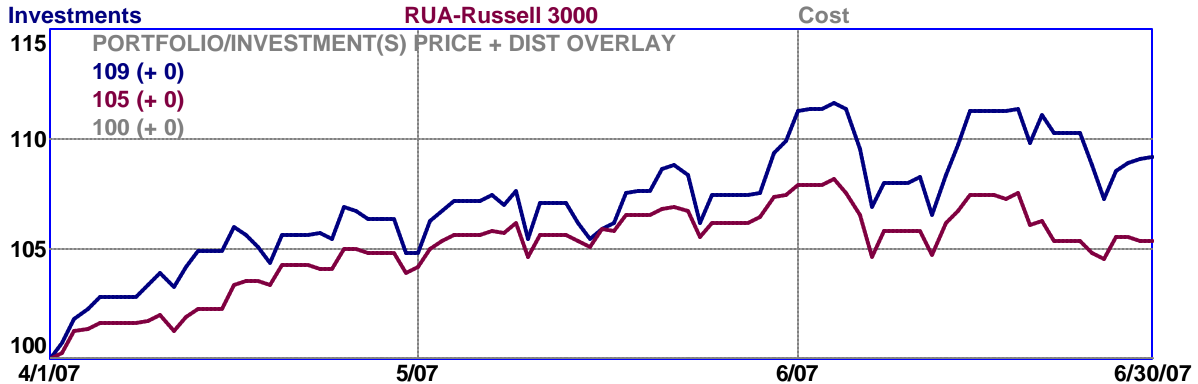
July 5, 2007

Clients,

Second quarter annual rate returns of 40% were excellent. As shown in the chart, our returns were almost double the benchmark Russell 3000.

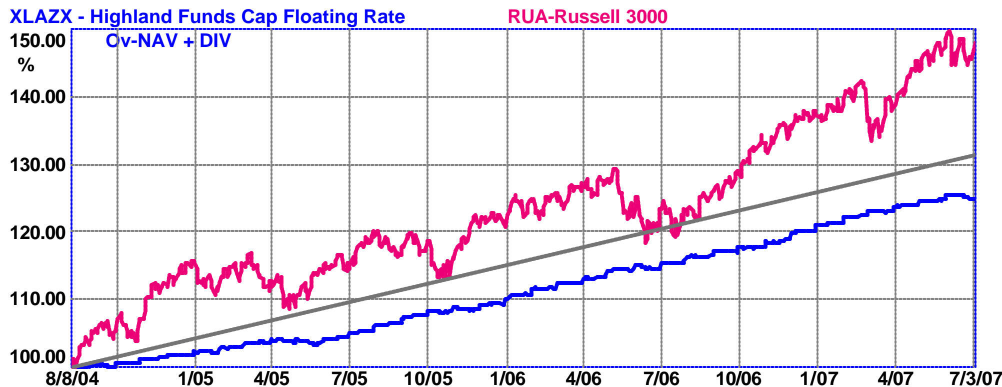



Strange as it may seem, the high returns make some people nervous. At the casino where the laws of large numbers favor the house, if you are way ahead it makes sense to cash your chips and go home. The laws of large numbers also work in investing, but to our advantage.

Over the last five plus years I have had very few clients take their chips and go elsewhere. Two or three of those clients were in volatile strategies, such as the Prudent Speculator newsletter, and chose to exit at a loss. However, just as many exited with return rates that were good or even spectacular – at 20% or 26%. What goes up does not have to go down. As Nicholas Vardy, one of my recent favorite investor guides, says: "There is always a bull market somewhere."

A friend (and prospect) came to see me last week concerned about what might happen to stocks and the US economy. I first asked her one of my favorite questions: "In today's world, are the best stocks to buy different for the person living in the United States, in Germany, in Japan or in Brazil? If so, why?" Not only are world economies changing fundamentally with billions of people gaining access to home mortgages and a middle-class livelihood, but investment options offer us ease and transparency for investing internationally. How do you even define an international allocation? Obviously, country ETFs and ADRs might seem international. But those foreign ADR companies might have major operations in the United States, and over half of all profit from US public companies now comes from international operations. We are not as dependent upon the US market.

Getting back to my anxiety about your anxiety about volatility, I sketched for her a chart such as the one below and asked which investment she would prefer.

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*(The chart shows a comparison between the Russell 3000 market benchmark, and a fixed income investment we have held for some time in an account that really can't tolerate much volatility. It has returned 10% annually over the time period of the chart – better than most money markets.)*

Her first reply was that she would prefer the less bumpy ride of the blue line. The next question is, "At what point in time would it be better to be in the fixed, blue-line investment rather than the volatile one?" Obviously while one can get a down draft right at the start, in the chart the volatile investment is ahead at all points in time.

I find it helpful to draw trend lines such as shown in grey under the bouncing equity line for each stock and each portfolio. Such a line is also helpful for looking at the whole of your investments. Above the line, it is not solid money but rather what the market needs to breathe in and out and take its normal seasons. When things go below the line, it is time to get concerned and start selling. The real danger is not news-driven panic that gives market extremes, because such things correct in a few months. The real danger is a longer, slow slide that never triggers an exit. This is what happened to too many people invested in large-cap tech stocks in the early part of the decade.

For most of your accounts I have had 5% or so in a timing portfolio that when invested moves at 150% of the mid-cap market. On June 27 (pink + on the chart below) the price dipped below my trend lines, precipitating a sale. As it turned out, I should have waited an hour because things turned around and now I'm waiting for a reentry. This is not a business for anyone who needs to always be right; we are mostly right and are going to guard against the slippery slopes down. Sometimes that is for a specific position, as is the case in this timing portfolio. At other times it means guarding the total balance, even if individual positions may vary dramatically.

Still on the subject of volatility, using the planning Monty Carlo spreadsheet available on my website, I recently discovered that with an $800,000 investment in Treasury Bills (money markets), and withdrawing only $10,000 a year for twenty years, adjusted for inflation, the account would go negative 175 times out of 1,000 simulations (17.5% of the time), based on randomly selected years from 1928 through 2006. The same investment getting equity market returns and with the same withdrawals does not come up negative one time in the 1,000 simulations. If risk is defined as the probability of running out of money, the "more risky" equities have far less risk than the "safer" fixed income investment.

You may find that planning spreadsheet on my website a little overwhelming, as it was designed for me to use with you at my desk. I would be happy to do that if you have an interest. We could put in the numbers for your mortgage, taxes and lifestyle anticipated over future years to get probabilities for future net worth based on different lifestyle and investment scenarios.

Lee