No Longer Avoiding Growth

I have the embarrassing distinction of having written an article with this title in my March 2000 newsletter, within a week or two of growth investing's peak. In the article I examined Forbes columnist Kenneth Fisher's conclusion that 'high price-to-earnings ratios are not really risky'. I stated *I conclude that the US markets are not likely to fall sharply, and stay down, until they **first** have a number of low return (or small loss) quarters. For then you would have the combination of an overpriced market, **plus** disgruntled investors. Until then, I suspect that market drops will be limited in depth and duration due to the 'buy the dips' mentality that has served us so well over the past several years*. It is clear that in the past two and a half years we have met both requirements, the number of poor return quarters and still an overpriced market, and this 'permitted' further sharp declines. In March 2000 I had recognized the presence of this risk, however I had misjudged its likelihood due to a variety of factors, not the least of which were terrorism on our shores, a new war beyond our shores, and deep corporate mismanagement.

Other than to beat myself up, why do I raise this painful topic? I raise it because **we may well be in the midst of the inverse situation**. Since I consider the stock markets to be fairly valued, it is worth turning my March 2000 conclusion around: "I doubt that the US markets will rise sharply, and remain up, until they **first** have a number of strong return quarters. For then you would have the combination of a fairly priced market, **plus** optimistic investors."

The level of the stock market is driven by two factors, the strength of the future profits of the stocks in the market, and the level of optimism/pessimism of its investors. This optimism level can be tracked by the ratio of a stock's (or market's) price divided by its earnings. This is the 'high price-to-earnings ratios' mentioned by Kenneth Fisher earlier.

My conclusion in the March 2000 article was that the investor optimism could overwhelm the future profitability factor for (very) extended periods of time, and that it seemed likely that it takes investors several quarters to abandon **either** 'the only way is up' **or** 'the only way is down' train. I feel that this conclusion still stands, and that **the current pessimism is feeding on itself, but will eventually dissipate.**

John Neff, the manager of the Vanguard Windsor fund from 1964 until 1995 was interviewed in this week's Barron's. 'Consequently, he thinks **the US market probably has seen its lows, although a rousing recovery is unlikely to follow**: "The averages will appreciate 6%-7% annually, with a 2% yield, giving you an annual 8%-9% total return over time," Neff says. "But they might do nothing for the next two years. This is a 'you stop getting killed, and maybe the volatility moderates' situation." Hmm, I wouldn't mind a 'you stop getting killed' environment.

What should you do? The portfolios of many investors are positioned too conservatively to benefit enough from a rebound, even a gradual one. It took more than six months to see that the mid-2000 declines were more than dips, and that March 2000 was a peak. Finance professor Meir Statman describes **hindsight bias** as follows: "A few years from now, after the market has bottomed, people will look back and say, 'Any fool could have seen it was a bottom and that you should have jumped into stocks. But today, it isn't obvious where the market bottom is.'

If you have moved money to the sidelines, or if you haven't had the stomach to rebalance and buy more stocks in the past year or two, **your portfolio likely has a greater amount invested in money markets and bonds than 'usual'.** This has served you well in the past two years, however **this will work against you in good times**.

Future downside risk may well be greater for bonds than for stocks. Yields on bonds are very low, and this sharply increases the risk to bond investors, for bonds lose money when rates rise. **The 5-year Treasury note yields 2.67%, lower than it has been in the past forty years.** Over 800 stocks, or more than 10% of the stocks covered by Value Line, yield more than 5-year Treasuries. With stocks at four- and six-year lows, their future downside may well be limited, while bonds could fall quite a bit when interest rates rise.

Each of my clients has an Investment Policy Statement, which all investors should consider creating. In it you should examine your goals and your tolerance for investment uncertainty. You should describe the cash flows to/from the portfolio that you expect, and any unique considerations. This should help you determine a long-term investment approach, including a target 'asset allocation'. This allocation should identify the balance between risky (stock) and safer (bonds and cash) investments (perhaps 60% stocks and 40% bonds plus cash). Most importantly, try hard to have this game plan be a long-term one, limiting the influence of current market pessimism. Then, in the execution of this plan, try to do what Yogi Berra said, and 'plan the play and play the plan'.

Volume 6, Issue 3 September 25, 2002

The Mallard Message

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Inside This Issue

Autumn Plans

I will be attending some of my son's football games and basketball games this fall. I will also be attending the NAPFA Northeast/MidAtlantic Regional Conference in Baltimore from November 13-16. Major speakers will include Jeremy Siegel from Wharton, Knight Kiplinger, and Don Phillips from Morningstar.

Whenever I expect to be away from the office for more than one business day, I send an email to my clients. I also check my phone messages and return all urgent ones while I am away. I regularly check my normal email from the road, via a spiffy service called **GoToMyPC**.

Conference Report

In the past few months at the local financial planning study group I have heard presentations on oil and gas partnerships, managed futures, and estate planning with family limited partnerships. I have also been working on organizing the 2003 NAPFA Northeast/MidAtlantic Regional Conference, to be held in Philadelphia.

Frequently Asked Questions

1. **How is the 'Merger' going?** We have completed the bulk of the administrative chores. We have formed Mallard Advisors, and have registered it with the Securities Exchange Commission and with our primary custodians. The website was enhanced and moved to www.mallardadvisors.com. The office enjoyed a face-lift this summer, and we celebrated our changes with a very nice Open House on September 17th. We will be providing our existing clients with new Mallard Advisors contracts in the coming weeks.
2. **Who is Bill Starnes?** Bill has worked at a local financial planning firm in Hockessin, Delaware for four years, and has earned the CFP and ChFC designations, and a Masters degree in Taxation. I have known Bill through the local financial planning study group during these years, and have referred clients to him for financial planning. It was through this process that I have seen what a great job he does for clients. Pam's column in this newsletter is an interview of Bill, so you can learn more about him.
3. **When will you next offer seminars?** Bill and I will be offering a lunchtime seminar, **TIAA/CREF Planning**, on Wednesday November 6th from 11:30am to 1pm at 110 Clayton Hall on the University of Delaware campus. This seminar is part of the Delaware Financial Literacy Institute, better known as the Delaware Money School (**www.delawaremoneyschool.org**). Call our office for more details.
4. **Where can I learn more about Mallard?** The Mallard website is www.mallardadvisors.com. If someone asks you for information on Mallard, please don't hesitate to refer them to the website, or suggest that they call us at (302) 737-4546. **The current disclosure document, Form ADV, and the Mallard Privacy Policy are now posted on the website.**

Maybe Investing Is Brain Surgery

I have often argued that a major disadvantage we have as investors is that we are human. As such, we wage a battle between our head and our heart. Of course our emotions are not locked in our heart, but in our brain, and this is described quite well in an article by Jason Zweig entitled "Are You Wired For Wealth", in the October 2002 issue of Money Magazine. MIT's finance professor Andrew Lo states "how the human brain works and why we react the way we do to various situations are critical for developing a better understanding of the common mistakes that typical investors make."

Deep in the brain is the amygdala, which is a 'kernal of hot, fast emotions like fear or anger', that drives our "fight or flight" response to threats. When we see a brake light ahead of us, the amygdala fires instantaneously, enabling us to quickly move our right foot to our own vehicle's brake pedal. The amygdala also responds to the threat of emotional distress; one study found that 'even the expectation of (investment) losses sets off a burst of activity in the amygdala.' Furthermore, '**activity in the amygdala can trigger the release of adrenaline, which has been found to "fuse" memories, making them more indelible**.' It is difficult to overcome these 'sealed' memories. For instance after a sharp decline in the stock market, it is hard to resume investing.

The amygdala also creates 'emotional memory', which we use to distinguish between actions that have been pleasing, and painful, in the past. I**n the absence of actual emotional memory, however, we can overestimate the strength of our intellectual convictions.** Thus, when we lack emotional experience with a potential situation, we increase our reliance on our intellectual conclusions, often to our detriment. 'Thanks to a streak of glorious gains in the late 1990s, these investors' amygdalas had never been ignited by a major financial loss. That led all too many people to the mistaken conclusion that big losses wouldn't bother them.' Many investors find that they were much less risk-averse when the markets were strong, but that once they had accumulated emotional memory of the pain of investment losses, their risk tolerance has plummeted. This is due to the brain's trickery, its tendency to discount the importance and likelihood of situations in which you lack experience.

Two sections of the brain (the nucleus accumbens and the anterior cingulated) create what Zweig terms 'the **prediction addiction**', the drive to find patterns (where they exist and even where they do not), and to identify where patterns found in the past are violated. 'If a stock goes up a couple of days in a row, or a company reports improved earnings for a few straight quarters, we immediately think we know what's coming next…. **Our brains are hardwired to project the past into the future.**' This prediction addiction also creates fear and anxiety when past patterns are broken. This creates a tendency to react disproportionately when stocks disappoint, when a rising earnings record is broken, even by only a penny per share. This addiction causes us to speculate when objective analysis may yield a different conclusion.

Dopamine is a chemical released in the brain that produces a 'natural high'. Researchers have found that long shots produce a higher level of dopamine, and thus 'dopamine makes winning **big** feel vastly better than just winning—and … prevents us from focusing on how small the odds of winning big actually are.' Lotteries rely on this relationship. Ivan Pavlov found his dogs associate cues and effects, and when the expected effect is positive (being fed), dopamine can be released when the cue is encountered (a bell is rung). This gives a "prediction high". The human brain works the same way. In 1999 'day traders got a "buzz" just from sitting down in front of their computers if their previous trades had been profitable.' When the prediction fails to pan out, however, in less than two seconds the brain can swing to depression. This 'may help explain why the market so harshly overreacts to any short-term disappointment', and so positively to unexpected good news.

What Can You Do? Zweig suggests developing "automated, irreversible investing habits that are tailor-made for **neutralizing your brain's worst liabilities while optimizing its greatest assets**'. This includes dollar cost averaging, semi-annual rebalancing, and broad asset diversification. I like the suggestion to build an 'emotional registry', a written record of your feelings. When you feel compelled to suddenly sell a stock, first refer to your registry and see if this reminds you of an earlier 'flight', a move that you later regretted for having been done in haste.

To shield yourself from the amygdala's almost irresistible force, 'promise aloud or in writing, before a friend or family member who can hold you to it, that you won't check the value of your accounts more than once a month.' Also, review your tolerance for investment risk now that you have 'actual emotional memory', and incorporate this in your investment game plan.

Chinese philosopher Sun Tze said "Know thine enemy and victory will be forthcoming." Understanding how your brain processes investment decisions can only help.

Top Holdings

In this section I review top holdings for client accounts (greater than $100,000 when consolidated), and purchases or sales of $50,000 or more for the past three months. The data for this report comes from the September 15, 2002 positions and for transactions during the prior three months. There were no dramatic changes in the past three months, other than a 12% decline in the S&P 500.

Mutual Funds—Artisan International, Artisan Mid Cap, Columbia High Yield, Dodge & Cox Stock, Fidelity Diversified Int'l, Fidelity Long-Term Income, Fremont Bond, Janus Overseas, the Merger Fund, Royce Low Priced Stock, five TIAA/CREF subaccounts, two Vanguard stock index funds, three Vanguard bond funds, Vanguard Variable Annuity Equity Index, and William Blair Int'l Growth are all large holdings. I added $80,000 to Fidelity Long Term Income, $50,000 to Fremont Bond, and $220,000 to Vanguard Index 500, and I sold $220,000 of Vanguard Total Stock Market (this was done to capture a tax-loss).

Specialized Funds—No closed-end funds are held at $100,000 or more. iShares Russell 1000, MSCI EAFE, S&P 500 SPDR, and S&P Midcap 400 are the top exchange-traded fund holdings. I reduced MSCI EAFE by $70,000 (done to capture a tax loss and to swap into other foreign investments).

Bonds—I added almost $500,000 in very short-term bonds (maturing in less than a year), as almost $400,000 in short-term bonds matured.

Stocks—Due largely to the drop in AstroPower's share price, and to our partial sale, it is no longer a top holding. GE remains at $100,000 or more.

The Scoop on Bill

[In this article Pam reports on the new firm from the perspective of a current or prospective wealth management client. She interviewed Bill Starnes, asking questions that many of you may be thinking.]

How is Mallard structured?

We have created two divisions. Paul leads the wealth management division and I lead the financial planning division. Paul's clients remain his, under the wealth management division, and my clients remain mine, under the financial planning division. There are a small number of clients who receive services from both divisions, from both of us.

What do you do?

I help people define and prioritize their financial goals so that they can be achieved smarter and faster. I address client questions and concerns with an objective opinion on how they can save money, improve results, simplify their lives, with recommendations that they will feel comfortable implementing.

How do I use your services / what is your process?

To get started with Mallard's financial planning services, simply call me so we can see if scheduling a free initial consultation would be beneficial to you. I would be pleased to mail to anyone a brochure describing my financial planning services in greater detail.

Who's your typical client?

Most of my clients have financial affairs or questions that have gotten more complex than they feel comfortable handling. For example, someone who is considering retiring but wants to be sure they will be able to maintain their current lifestyle, or has an irrevocable pension decisions to make.

What is your fee schedule?

I have two levels of services. A checkup style review typically ranges from $500 to $800 and a comprehensive plan typically ranges from $2,000 to $5,000. Retainer fees also depend on the complexity of the situation.

How do you stay current?

I complete at least sixty hours of continuing education every two years, in the six areas comprising comprehensive financial planning.

Are your financial planning services an on-going commitment?

Initial planning is done either as a stand-alone service, or as part of an ongoing retainer arrangement.

If I am currently Paul's client and need some financial planning advice, must I use your services?

Absolutely not. Both Paul and I have always made a point of referring our clients to whichever advisor is best for them and this will always be our first priority.