Perspective

July 2012 By Davis Riemer

DHR Investment Counsel, Ltd.
The Fine Art of Wealth Management

After many months (four years!) of a daily din of news and speculation about markets, economies and nations, one can become de-sensitized. Then, after a while, wonder: *What's Happening?* Amidst global turmoil, what should one do? Does it seem like the world's economic engines are stuck in neutral, idling, waiting – for some unseen stoplight to change? What are we investors doing as we watch jittery markets jump forward and back with little discernible effect on longer term outcomes? Are we losing interest because the markets are stagnant? Are we becoming inured to the volatility and just waiting for something definitive to happen? What does the media have to say in such times? Does the daily reporting on finance help our thoughts? Or, does the media seem to be more self serving than illuminating? What is DHR doing?

The subjects of this *Perspective* relate to the current situation and include:

- Funeral announcements for the death of equity investment.
- Two traps on the road to long term investment success.
- Mutual fund costs in our clients' investment portfolios.
- Two aspects of DHR's service – one old but not well known and one emerging.

In writing these various sections, I have drawn some material from the work of others. Briefly, credit is due as I show below. (My history professors would pass out – or at least not pass me, if they saw my citation habits. Please let me know if you want more detail in citations.)

Funeral Announcements and *Trap One:* Weston Wellington, Dimensional Fund Advisors

Trap Two: R. David McLean, MIT *Fooled By Compounding,* in Journal of Portfolio Management

Funeral Announcements for The Death of Equity Investing

The recent years through 2012 are not the first period in which U.S. investors have had long stretches of stagnant or negative investment experiences. They always produce questions about what one should do. At such times, we find that it often helps to look back at similar periods in the past, to see whether they can offer any guidance about how to understand the current situation. Since markets move in cycles, it is not surprising to find times in the past that look like today, and then to read words from experts and opinion leaders about what to do. One such period ended in 1982, with a meaningful blip and sources of advice in 1979. Lesson: Don't believe everything you think.

Quotes from: 1979: *Business Week,* "The Death of Equities." 2012: *The Financial Times*.

2012: "Stocks have been so far out of favor for half a century. Many declare the 'cult of the equity' dead."

1979: "This death of equity can no longer be seen as something that a stock market rally – however strong – will check. It has persisted for more than ten years through market rallies, business cycles, recession, recoveries and booms."

2012: "The rules of the game have changed."

1979: "We have entered a new financial age. The old rules no longer apply."

2012: "Few people doubt, however, that the old cult of equity – which steered long term savers into loading their portfolios with shares – has died."

1979: "Today, the old attitude of buying solid stocks as a cornerstone for one's life savings and retirement has simply disappeared."

Although they might not use the same words, we suspect that a number of investors – perhaps even DHR clients – have feelings similar to those expressed in these quotes. The volume of media reporting on economies and markets has literally been a barrage in the last four years and - with only a few, short-lived exceptions – also consistently negative. It has affected the way people think and feel. When considering how to invest one's portfolio today, in the context of political paralysis, economic stagnation and the potential collapse of entire national economies, it is difficult to sustain an optimistic outlook.

Well, ponder this: Imagine you are back in 1979. You visit your financial advisor, who recommends that you remain invested in stocks, as you have been. But for the last ten years, "as you have been" has yielded paltry or even negative results. What do you say?

Let's review what happened after your imaginary meeting in 1979. The market went up – briefly. Then, it started to fall again, which continued until August, 1982. Then what happened?

Early that month, I met with a colleague, a market timer, whose portfolio was "all in cash because the market looked closer to a bottom than a top." The next week, on August 13, the domestic market began one of the longest, strongest bull markets in its history. Here are the results:

Anniversary	Price Date	% of Growth
1st Anniversary	August 12, 1983	58.3%
5th Anniversary	August 12, 1987	224.5%
10th Anniversary	August 12, 1992	307.9%
20th Anniversary	August 12, 2002	782.4%
(Almost) 30th	June 19, 2012	1,225.9%

If you look at the long term results of the markets over the past fifty years, you will see a 17 year period of underperformance by stocks, ending in 1982. Then, as the results above indicate, equity investors were rewarded for their patience and discipline. This "reward" is what we expect when we invest in stocks. Economic theory and historical evidence support that expectation. However, as they say, "timing is

everything." Does that reward tell us that ours is next? No. Stocks are genuinely risky. There is no time period - even measured in decades - over which we can be assured of receiving a positive result.

How should we react to pundits' (premature) announcements of funerals? Should we believe them or should we regard the forecast as a contrarian indicator? With dozens of experts making predictions, some of them are going to be right. The "expert" opinion today says: ***"Risk! Risk! Risk!"*** Because we are human, when events move towards extreme levels, few investors can successfully apply the principle that risk and return are related. But these experiences offer compelling evidence that risk and return are related. When risk runs high, so does the opportunity for return. When return runs high – risk increases. As an example of the latter, think back to 1999, when we had four years of superb returns on one sector of the stock market. Investors were not eager to apply that principle then either. At the end of 1999, the S&P500 had risen more than 25% each year for four consecutive years. The popular perception was that there was little or no risk in equity investing, so people literally almost threw money at tech stocks. The close of the year was followed, of course, by a massive decline in prices.

Just as it did in 1982, the financial risk today feels palpable. Nevertheless, mistakes in applying the observations of history contribute to the fact that many investors fail to achieve all the returns that markets have to offer. Professional advice can help.

> ***"How poor are they that have no patience; What wound ever healed but by degree?"***
>
> **- Iago, Shakespeare's Othello**

Trap One: On the Road to Long Term Investment Success

Conventional wisdom holds that "On the Road to Long Term Investment Success, an intelligently chosen list of stocks will do as well as – nay, better than – the "average" of the market."

I suspect that almost all our readers remember their investment experience in the late 1990's, when the tech industry was ***"the new thing,"*** its companies' stocks rising as though lighter than air and, for assured investment profits, the world was convinced that you had to "be there or be square." We all know what happened. One of the great myths of the investment world is that you can build a successful long-term strategy around a carefully chosen small number of stocks. Since that idea has persisted over time, it is useful now and then to assess and analyze the results of concentrated portfolios, even those chosen by experts.

In mid-2007, the Australian Financial Review's (AFR) *Smart Investor* magazine published a front cover story called "VIP Stocks — 25 Companies that Grow Earnings Year after Year." (Their "VIP" = *Very Impressive Performers*). In a manner almost identical to the work of many U.S. analysts and investors who work from the S&P500, the AFR's sophisticated analysts studied Australia's top 500 listed companies to select their list. They selected the 25 companies that they agreed had the best potential for growth. However, as it turned out in the year following the publication of the list of those "Very Impressive Performers," less than a third performed better than the market. Eighteen of the 25 underperformed the market and of those, 12 lost 60 per cent or more of their value. In fact, two companies disappeared!

In the four years from 1996 through 1999, led by the list of companies in the tech sector, the S&P500 grew more than 25% per year. In our market's history, this was unprecedented. That made it clear to many investors that the rules had changed. One had to adopt the new idea - "invest only in 'the new thing' - tech stocks." Unfortunately for most of those investors, in 2000 their "new thing" revealed itself to be an

unmitigated disaster, with price declines in portfolios reaching 90%! Those who had said "It's different this time" were proven disastrously wrong. The established relationship between risk and return remained in place.

In the 1970s, I encountered the "Nifty Fifty." The term "Nifty Fifty" referred to 50 large companies in the 1960s and 1970s. Each company was a leader in its field with a strong balance sheet, high profit rates, and double-digit growth rates. Sophisticated institutional investors were infatuated by the Nifty Fifty, thinking that a portfolio so constructed could always be bought and should never be sold, regardless of the price of its stocks. Then, in 1973, the stock market crashed. But, held up by institutional enthusiasm, the Nifty Fifty briefly resisted decline, creating a two-tiered market similar to the tech bubble in the 1990's. At the top - a few richly priced members of the Nifty Fifty club. Not at the top - the depressed rest. Then, from their 1972/3 highs to their 1974 lows, Xerox fell 71%, Avon 86%, and Polaroid 91%.

There were several nifty lists of fifty, of which the two most prominent had 24 stocks in common. Those 24 - *The Terrific 24!* - have not done well. Jeremy Siegel, a prominent economist, calculated the results for them as of December 31, 2001. An investor who bought those 24 stocks at the end of 1972 would have had 50 percent less wealth at the end of 2001 than an investor who bought the S&P 500. Hmmm. What price expert advice?

Some investment professionals pay little attention to small companies, so for them the "master list" from which to make selections starts with the S&P500 and then runs to about one thousand companies. For those who consider the entire market, there are 5,000 stocks. As the number of investments in a portfolio drops below the number in the total market, risk increases. That risk is comprised of variability, under-performance and the potential for long term loss. When the portfolio's list shortens to 25 positions, the risk increases substantially, regardless of what the list's promoters have to say about it. Two dozen is a common portfolio size for active stock pickers, but consider: It is 2.5% of 1,000 companies and 0.5% of 5,000 companies.

Investment success depends upon what happens next. But – conundrum - we don't know what will happen next. That's why we diversify.

> ***"Diversification is your buddy."***
>
> **- Merton Miller,**
> **Nobel Laureate**

Trap Two:

Conventional Wisdom also holds that "On the Road to Long Term Investment Success, the historical performance of mutual funds provides information that can enable one to choose a profitable investment."

Many investors examine the historical performance record of a mutual fund to see whether they should invest in it. Others go one step further and compare that record to a benchmark, e.g. the S&P500. Even having heard that past performance does not predict future performance, some still look at longer periods, believing that the longer the period the more reliable the conclusion. Doesn't a longer record indicate greater consistency of outperformance or failing performance? Well – no. Not necessarily. It is necessary but not sufficient. We have all heard that past performance does not predict future performance. The following paragraphs illustrate one of the reasons for that statement - past performance *does not always tell you the truth of the history!*

> ***"Only buy a stock if it goes up.***
> ***If it doesn't go up, don't buy it."***
>
> **- Will Rogers, Humorist.**

Let's say that you analyze a fund (we'll call it Fund "A") with a five year record. As you read this, when you read "benchmark" you may think "index fund" and when you read "Fund A," think "Actively Managed" fund. Suppose that, at the end of the five year hypothetical investment period you examined, an investment in Fund A had risen to a higher "terminal value" than the benchmark. For example, at the end of five years, Fund A might have provided $11,000 but the benchmark only $10,000. Can you correctly infer the cause of the greater profit by looking at the growth chart over that time? Isn't it simply the investment expertise creating value over that period of time? Should you use that inference in a decision to invest? No, you shouldn't. The higher result might have two components, both of which matter to the decision and as yet, you know only one of them.

Of course, the compounding effect of the initial investment over time produces profit. If all other things remain equal, that will tell the story of the investment in an appropriate way. But other things are not always equal. Another component is variance of the performance of the fund – negative or positive – as compared to the benchmark.

As an example, let's make two assumptions about the performance of Fund A with an initial investment of $10,000. First, assume that, during the first year of a five year comparison period, Fund A had performance of +13.5% while the benchmark grew by 10% so that, at the end of year one, the fund has $11,350 of value and the benchmark has $11,000. Then assume that, in every one of the succeeding four years, the fund and the benchmark both generated the same returns of +10%. From an investment of $10,000 on day one, the fifth year terminal value in Fund A would be $16,618, while the fifth year terminal value in the benchmark would be $16,105. Nice - $513 extra profit for your diligent research. Invest in Fund A? *But remember, the extra value in year one would not be available to you as a current investor.* Furthermore, given that during the last four out of the five years of existence, the fund did not do better than the benchmark, one has no good reason to expect that the year one success will recur. During the greatest part of the period the investments performed the same.

What happens to the discrepancy if we examine a longer period? The "longer period" is supposed to provide greater reliability than a short period. *But, not necessarily!* The effect of compounding distorts the difference more and more as time passes so that, by year ten, the premium has grown to from $513 to $826, even though during the last nine of the ten years, there was zero difference in the performance of Fund A and the benchmark. And still, *the value in year one would not be available to a current investor.* This means that an analysis of longer periods can produce increasingly larger errors in conclusions.

The reader can understand that it makes no difference whether the abnormal return in the short period was positive or negative. The point is that the major influence over time resulted from the compounding of the "head start," not continuing investment prowess. If this influence is not separated out, one cannot understand what happened.

When we bring this understanding to the mutual fund industry, we discover a "secret."

> ***"It's frightening to think that you might not know something, but more frightening to think that, by and large, the world is run by people who have faith that they know exactly what's going on."***
>
> **- Amos Tversky, Psychologist and Founder of Behavioral Economics**

The investment business resembles other businesses in many ways. For example, a manufacturer might try several variations of a new product, to find out which one the public prefers. Nothing wrong with that. When deciding to start a new fund, mutual fund companies often “incubate” several, similarly but not identically managed funds for a period of a few years. Although “incubating funds” are not available to the public for investment, they do have money in them and so they develop “real-time” track records which can be cited to the public when the fund eventually “goes public” and states its track record. At the end of the incubation period, the company selects the best performer of the group and offers it to the public, describing its success in the sales literature. How does that affect ongoing statements of performance of the fund? For years, just as in the example on the preceding page, such displays will show the fund remaining ahead of the benchmark in accumulated wealth. However, just like the example on the preceding page, the event that caused it was not available to the current investor. Such information – or lack thereof - can lead an investor to mistaken inferences and bad decisions. Furthermore, these numbers also appear, without an accompanying disclaimer about the above investment math, in independent sources of investment reporting – newspapers, magazines, even industry sources like Morningstar, for example. So, *Caveat Emptor!*

Mutual Fund Operating Expenses: Notes on Following Table

Our clients understand that they pay three costs in their long term portfolio management. They pay advisory fees to DHR and transaction costs to Charles Schwab & Co. In addition, like all mutual fund investors, they pay the fund company, through the mechanism called the “Operating Expense Ratio.” (OER) The fund companies levy this charge on the total assets in the fund, and the OER number tells you what percent of the portfolio they charge. It is taken “off the top,” often daily.

The chart on the following page compares the Operating Expense Ratio (OER) of several funds from each of the two investment companies whose funds DHR uses most frequently and, in addition, the average OER for all funds in each of the asset classes, taken from Morningstar. The Vanguard numbers relate to their “Signal” share class, available to you through us as an advisor, which has a lower expense than the regular retail investor share class. We are pleased that we can pass on this type of cost saving to our clients.

We understand that questions might arise about why we use any fund company other than Vanguard. Briefly, although many people think that DFA and Vanguard are basically the same, they have significant differences in strategy. Vanguard’s strategies cost less to operate. But, an investor typically cares more about the final output – return – than the cost difference. If you still have the one we sent you in January, please examine the DHR “Performance Review of Selected Investments” which we publish annually. Compare the performance of the two companies over the last decade. These variables result from different approaches to market investment. We can address this in more depth in meetings with you, or in a later *Perspective*.

> ***“It is better to know less than to know so much that ain’t so.”***
>
> **- Josh Billings, wise person**

Costs can be a trap. Many investors look first (and often only) at recent returns, ignoring costs, strategy and long run records. This is a mistake. Recent returns are basically random. Costs are constant, strategy is determinative and historical performance – when meaningful at all – is only meaningful when properly understood and over long periods, not short.

Table of Operating Expenses of Mutual Funds

DHR Service: Account Monitoring

A few weeks ago, a client (for privacy purposes, we'll call him "Bob") sent me an e-mail expressing concern about the security of his account. He had felt caught between ignoring it and going online every day, to assure himself that there had been no unwarranted intrusion. I took the suggestion his e-mail (below) offered and, with edits for confidentiality, I include the correspondence below.

"Hi, Davis: Clients can worry about their accounts being hacked and drained and, worst of all, not finding out about it for weeks or months because they forget or are too lazy to check their balances regularly. The latter would include me. Could DHR have an automated system that checks every day for each of your clients and that would tell you if there was a decline of more than (e.g.) 25% in value from the previous day? I believe clients would value such a service."

"Bob: We actually do monitor accounts for that purpose now and have done so for years, in the following way. Each day, both Louise and I receive from staff, who has already examined it, a report on the flow of every dollar that goes in or out of all accounts. Naturally, although all flows matter, we look for larger sums and, when we encounter them, we examine the portfolio or call Schwab or occasionally even call the client. Although the printout of flows does not give us percentage numbers, we think the dollar figure is actually superior for the purpose."

"Davis: It sounds like you are indeed monitoring accounts on a daily basis to insure against such negative events. Now all you need to do is to announce to all customers that such policies are in place so they can sleep better at night and you can take credit for such proactive policies. ;) (And maybe encourage them to change their password to a longer more difficult one.)"

DHR Service: "Seasonal Wealth Management"

We have been thinking about our clients' families and their individual members, as events in the progress of time cause changes in their lives. DHR seeks to match our firm's service and value to the needs of our client families – as they change. We describe DHR's service as "Wealth Management" – management over time of all (primarily financial) sources of "wealth" for the accomplishment of the families' goals and objectives. This incorporates financial planning – the development of dollar resources to meet calculated dollar goals, the management of portfolios of securities, guidance on estate planning, support in tax planning, assistance with portfolios of life, medical and long term care insurance, as well as property, casualty and liability insurance, and the maintenance of a process that incorporates all those decision areas.

When one thinks of life's progress, the word "seasons" often comes to mind. It did for us. So, we recently added a term to the descriptor of our service, so that we now refer to "Seasonal Wealth Management."

Our clientele includes people in their 90's and in every age decade down to the teens. As our clients move through the seasons of their lives, we at DHR experience the changes in planning and finances that occur with every season's special challenges and opportunities. Retirements, births, Bar and Bat Mitzvahs, graduations, promotions, memorial services. And of course, there is also loss. Sometimes we experience deep, painful loss. When that happens, we must be patient. We must reinvent ourselves. Even this process however, can be a financial "season." Indeed, aside from losses of a personal nature, many of us experienced deep and painful financial loss in 2008, after which many of us had to reinvent ourselves through changes in career and financial plans. We had to master patience in ways we had not anticipated.

Among the seasons, we count that period during which the senior generation begins to wonder about the following one: *Will they be competent with money? Will they act responsibly? Protect what has been put together and passed on to them?* At DHR, we are developing service approaches to these questions, and have conducted this type of meeting with several client families. We have found three questions recur:

- *When do we talk to our kids about the estate? The money? My plans? My concerns?*
- *How much should we tell them? Details of net worth? Avoid totals?*
- *How do we go about it?*

If you are asking yourself these questions, we'd like you to know that we at DHR can help. We are constantly expanding our experience and service in this emerging area and would be pleased to discuss it with you.

DHR Investment Counsel, Ltd.
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5435 College Avenue, Suite 200 • Oakland, California 94618 • 510.596.2580 • www.dhrcounsel.com