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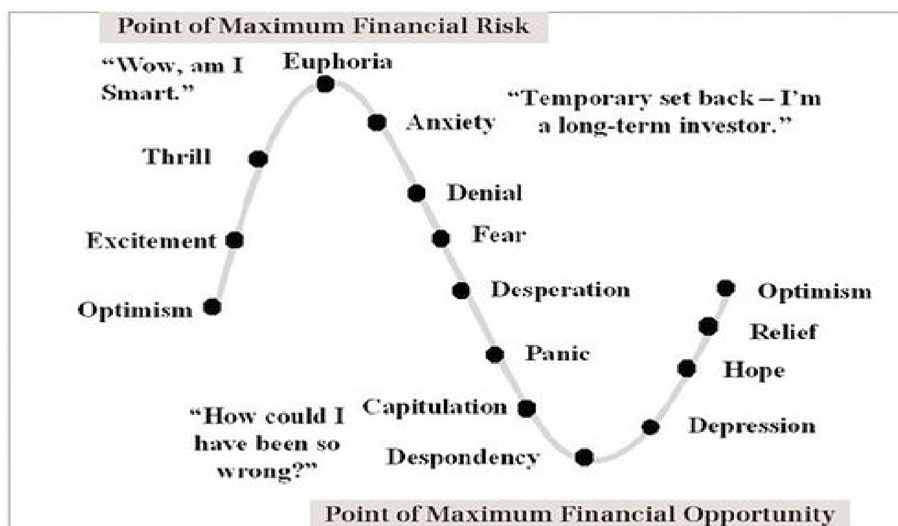
"He who conquers himself is the mightiest warrior."*—Confucius*

To our clients and friends:

Let me begin with an anecdote. Upon my arrival on campus as a freshman at the University of Notre Dame several decades ago, I initially opted for a major in chemistry. Shortly thereafter, I realized my mistake and switched to liberal arts—more specifically, psychology. To this day, my roommate (who I am still close to) remains convinced that the reason I switched to psychology was because the psychology building was the closest building to our dorm room! In any event, I am thankful that I majored in psychology.

Emotions play a major role in investing. From a psychological point of view, one of the biggest mistakes investors make involves a cognitive bias known as the "recency effect." This bias rears its head whenever we place exaggerated importance on what has just happened, while downplaying the significance of historical data. It's a common trait, which is why it's so important to always subject our hunches to statistical scrutiny.

The chart below demonstrates that the investor's greatest enemy is himself (or herself). By the enemy, I specifically mean an investor's *emotions.* History tells us that investors tend to increase their exposure to stocks just prior to a peak in the market, and to reduce their holdings just ahead of a stellar period of capital appreciation. In short, euphoric investors buy high, and frightened investors sell low.



Different versions of the above graph have been floating around cyberspace and on the pages of various financial publications for the past several years. You'll notice from the graph that the greatest *risk* actually occurs at the top of the curve (Euphoria) and that the greatest *opportunity* occurs at the bottom (Despondency).

The bottom line is that waiting until the backdrop feels "safe" to make an investment in stocks has historically not been a good method of achieving future returns.

And in fact, history shows that periods of turmoil and steep market declines have subsequently proven to be among the best times to invest (think October 2002 and March 2009). Despite this evidence, when markets falter, many market participants cash out—thus exhibiting behavior based solely on their *emotions* and psychological impulses.

Elements of an Effective Investment Strategy

As Confucius says (see the quote above), my goal is to help our clients conquer their fears and control their emotions when it comes to investing. At the start of every relationship with our clients, we create a *long term* investment plan—and strategy—that will look beyond *short term* issues like those we've seen this year and in recent years. In developing that strategy, our first step is to establish portfolio parameters based on each client's ***return*** requirements and ***risk*** appetite.

In doing that, I'm guided by a 1963 talk given by Benjamin Graham, the Columbia University professor whose students included Warren Buffett. Benjamin Graham is considered the "father of value investing" (I've mentioned him before in these newsletters). Here's what Graham had to say about portfolio construction:

> *"An investor should maintain at all times some division of his funds between bonds and stocks. My suggestion is that the minimum position of this portfolio held in common stocks should be **25%** and the maximum should be **75%**. Any variation should be clearly based on value considerations, which would lead him to own more common stocks when the market seems low in relation to value and less stock when the market seems high."*

That 25% to 75% range for stocks sets very broad parameters. Yet today, some investors resist owning any bonds, while others are out of stocks entirely, due to concerns about them being overvalued. Let's review the issues around bond and stock valuations.

Are bonds too risky?

Some investors have been misled by media characterizations of bonds being today's riskiest asset class—these investors therefore want to eliminate bonds entirely from their portfolios. This may be an overreaction—and it's probably a bad idea.

It is certainly true that a significant increase in interest rates would create challenges for bond investors. Despite that, I follow Benjamin Graham's advice by urging all clients to keep some bond component in their portfolios. As we saw in 2008, bonds can provide insurance against severe volatility in stock prices.

Given low rates on short-term government bonds, investors might find better yielding alternatives (but perhaps also higher risk) on convertible bonds, floating rate income bonds, high quality corporate bonds, and bank loans, along with some select foreign government bonds (but only those with solid finances and of the highest quality).

The concern over the impact that rising interest rates may have on bonds (and even stocks) may be exaggerated. In fact, there is growing sentiment that the current weak economic growth will result in low interest rates for many years to come.

To be clear, we should not overweight bonds in portfolios. I believe that for long-term investors stocks provide better prospects at this juncture, but I do recommend that my clients adhere to a minimum bond allocation as set out in their investment plan.

Are stocks set to fall?

The flip side of anxiety about rising interest rates for bonds is the fear that the recent run-up in stock prices makes them vulnerable to a severe correction. While there could certainly be a short term correction in stock prices, I continue to recommend that clients have a healthy stock allocation in their overall portfolio.

No one I'm aware of has demonstrated the ability to accurately predict *short-term* movements in stock prices—it is just as likely that stocks will rise by 20% as decline by 20%. Despite media hype, there is no such thing as a crystal ball in the investment world.

And for investors concerned about valuations being placed on U.S. stocks, there are high quality companies in Europe and Asia that sell for a significant discount to their U.S. equivalents. Overseas and international stocks have severely underperformed U.S. stocks for several years running—sooner or later that trend is expected to reverse.

Sticking to your plan

On page two of this newsletter, I tied together the quote from Confucius and the starting elements of an effective investment strategy. Most investors might politely nod their heads to the facts presented in the prior two paragraphs (pertaining to bonds and stocks). They might readily agree to initiate an investment plan for their portfolio—and effortlessly identify the parameters within which their investments will be managed.

But *agreeing* to a structured investment plan is simple—the challenge is *sticking to it.* It's easy to keep to your plan when things are going well. It's when investors get worn down by market declines and excessive volatility that sticking to their plan becomes more of a challenge. This is when some people lose their cool, and others may even experience full-blown panic.

This also explains why—when markets become choppy and volatile—some investors look for bold advice and seek dramatic shifts in their portfolio. For example, they may go to all cash or all stocks. Historical analysis tells us that the track record of those sudden and dramatic shifts is not a good one—and rarely serves the investor well.

During the tech mania of the late 1990s, many investors abandoned the principles of sound diversification. They over-weighted their portfolios with technology stocks. Ten years ago, U.S. investors began skewing their portfolios to banks and other beneficiaries of the real estate boom. In some cases, they extended themselves in order to buy bigger houses, vacation homes, and investment properties.

In 2008, demand from emerging markets caused a spike in commodity prices, and many investors dramatically increased their allocations to natural resource stocks as a result—right at the peak in prices in mid-2008. Remember when oil hit $150 a barrel?

While most investors know intuitively that broad diversification of their equity investments is critical, many find it difficult to stick to the original commitment to remain diversified. After a period of strong performance such as we've seen in the U.S., the instinctual response is often to "load up" on what's been doing well and to abandon what's been underperforming—history tells us investors should do the exact opposite.

And more recently, deviating from investment plans has taken a new form. In late 2008 and early 2009, the search for safety led to large outflows from stocks into bonds. This means that many investors missed out on the recovery from the market bottom. To the extent that investors were even buying stocks, many had an appetite only for stocks that paid high dividends. These high-dividend paying stocks were erroneously viewed as a suitable alternative to the secure income from bonds—this is not the case at all.

Conclusion

In the words of Confucius (again, taken from the opening quote in this newsletter) emotions can drive investors to behave in ways that are potentially detrimental to their long-term goals. In their search for a clear answer, many investors tend to abandon the plans they've agreed to during calmer times.

An excellent financial advisor helps individual clients to overcome uncertainty and fear by keeping them committed to a consistent investing plan and strategy—one that has the potential to fulfill their investment objectives. It's important for advisors to help clients retain a sense of perspective, and place events in the appropriate historical context.

I see my role as an emotional anchor to windward—keeping my clients' emotions from running away from them. Helping each of my clients adhere to their "grand plan"—sometimes against their instincts—is how I provide the greatest value. Sticking with an academically-proven, disciplined strategy may feel boring at times. But history shows that the key to successful investing is having a sensible plan, and then sticking to it.

Sincerely,

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Past performance is no guarantee of future results
Nothing contained in this quarterly newsletter should be construed as investment advice