THE MARKET PLACE

Analysis and Comment

all Street consultants and pundits are the unmatched masters when it comes to the creation and propagation of investment platitudes. Today we will be discussing some of my favorite clichés leading to all manner of investment mischief and wealth devastation.

“Invest For the Long Term”
Who among the faithful would take issue with this maxim? Is it not a truth held to be self evident? Well, what precisely constitutes the “long term?” According to Gail Dudack of Sungard Institutional Brokerage the following are the total real returns (i.e. appreciation plus dividends reinvested and adjusted for inflation) of the S&P 500 (and its equivalent before 1957) for the following long term periods:

The Years of Famine

<table>
<thead>
<tr>
<th>Time Period</th>
<th>Percentage Return</th>
<th>Number of Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>1882-1897</td>
<td>3.4%</td>
<td>15 years</td>
</tr>
<tr>
<td>1903-1921</td>
<td>0.6%</td>
<td>18 years</td>
</tr>
<tr>
<td>1933-1949</td>
<td>2.2%</td>
<td>19 years</td>
</tr>
<tr>
<td>1967-1992</td>
<td>0.2%</td>
<td>25 years</td>
</tr>
<tr>
<td>2000-2004</td>
<td>9%</td>
<td>5 years</td>
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Paltry investment returns by anyone’s standards – and over exceedingly long periods of time. In between these periods of investment famine, however, were periods of lush investment returns:

The Years of Feast

<table>
<thead>
<tr>
<th>Time Period</th>
<th>Percentage Return</th>
<th>Number of Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>1888-1902</td>
<td>13.6%</td>
<td>4 years</td>
</tr>
<tr>
<td>1922-1929</td>
<td>25.4%</td>
<td>7 years</td>
</tr>
<tr>
<td>1950-1955</td>
<td>14.1%</td>
<td>16 years</td>
</tr>
<tr>
<td>1983-1999</td>
<td>15.7%</td>
<td>16 years</td>
</tr>
</tbody>
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As we review the return history of the S&P 500, the 1983-1999 period was the period that produced the second highest compounded return and tied with the 1950-1966 period in terms of duration. The 1983-1999 period also introduced investors to one of the greatest speculative bubbles in recorded economic history. And, ladies and gentlemen, we were there, right in the middle of the insanity. For those who were smart enough, or lucky enough, to side step the decline this has been a very pleasant experience. (Messrs. Kahn, Lushbough and Robotti, take a bow.) Notice there seems to be some symmetry in the above charts: lean years of investment famine seem to be followed by rich years of feast – apparently ending in speculative excesses.

Now here’s my point: it’s easy to be a “patient long term...
investor" when the market is rising because the investor is being rewarded over the very short term – daily, weekly, perhaps monthly. I repeat: it is easy to be a patient long term investor when the market is rising because the investor is being rewarded over the very short term.

So investors have long time horizons only so long as they are engaged in an advancing stock market. But transition to a declining stock market and those same “long term investors” morph into trader’s – watching the gyrating prices of their stocks daily and basing their buy/sell/hold decisions on these gyrations. What investors say – even what they truly believe – and how they behave is as different as night and day. When investors are not being rewarded frequently their time frames collapse dramatically. If history repeats however, beginning with year 2000, investors may be in for a very long period of famine. But... investors are in this for the long term, right? We’ll see.

To understand the psyche of the average investor one must understand abnormal psychology. The simple truth is Wall Street is one nutty place where buyers and sellers meet, ostensibly to trade, but who inadvertently create confusion and fear, occasionally punctuated by episodes of greed and terror. But I digress. Let’s continue.

“The Safety of Fixed Income”

The decade of the 1970s was a period of relentlessly rising interest rates. Because the value of a bond is inversely related to its coupon, as interest rates went up, bonds declined in price. By the late 1970s and early 1980s bonds were crowned “certificates of confiscation” and Wall Street turned their backs on this asset. Not surprisingly, as fixed income lost public favor it gained investment appeal.

By the fall of 1981 the bond market was completing its “slow motion crash” as interest rates peaked. But like all financial instruments, whose gyrating prices reflect the emotional demeanor of its participants, cycles turn. At the point of maximum disrespect and pessimism non-callable long term U.S. bonds offered equity-like returns, absent the commensurate risk associated with equities.

(On July 19, 1989 Bob and I mailed our inaugural issue of Commentary. The following are the two closing paragraphs from that issue:

“... By investing at today’s historically high interest rates, we stand to do very well – as well as the majority of the best money managers with [performance] track records that span at least one full market cycle.

“And, if you are willing to assume the risk [of a long term bond] your performance is potentially greater still. If bonds retreat to the [100] year average of [4%], then, in addition to locking in today’s extraordinarily high interest rate, you will receive a capital appreciation kicker once these rates crack and head toward their historic levels.”"

Today, at a point of maximum popularity, long term U.S. government bonds promise to become, once again, “certificates of confiscation.” Today’s income-starved retiree and shell-shocked equity investor are stampeding into what is perceived as “safe.” Consider where this avalanche of cash is going: mortgages (despite the effective “call” option!), high coupon corporate paper (despite questionable quality), and long term government paper (despite the lowest interest rate environment in almost 50 years).

“Style Box Investing”

Most professional money managers have become ensnared by the demands of consultants who police and pigeonhole money managers into style boxes. Some money management firms are identified as “large-cap growth”, others as “small-cap value” others as “mid-cap blended” and still others as “growth at a reasonable price”. The investment universe can be sliced and diced in more ways than you can possibly imagine and is limited only by the creativity of one’s marketing department. The purpose of this entire style posturing is, from a consultants perspective, to foster the illusion that they are adding value. From the marketing department of the money management enterprises, it’s to “position” one’s firm – to differentiate themselves. To think that one has a diversified portfolio simply because they have a mishmash of “styles” cobbled together into a “portfolio” is ridiculous.

Who cares if the stocks purchased are large or small, domestic or foreign, value or growth, etc. so long as they are safe – we will discuss safety in a moment – and with a reasonable return expectation. Notice I said “reasonable” return expectation. Only a fool would stretch for return and, in so doing, risk permanently impairing their capital.

Why would anyone in their right mind sell a superior holding simply because it grew from a small-cap stock to a mid-cap stock? Isn’t that what we all hope for? What genius figured out that it was a superior investment strategy to sell a successful holding exclusively because it was successful, but no longer qualified because it grew too much? Adding insult to injury, these highly paid consultants then require that the cash proceeds from the sale must be redeployed to purchase a new small-cap holding, even if the new holding is of inferior quality. This makes no sense to me, and yet this is a bedrock tenet of Modern Portfolio Theory (MPT).

As an aside: If the investor is lucky, the small-cap stock that grew to become mid-cap may be purchased by the mid-cap manager of their “multi style” portfolio. Best case, the investor still owns the stock (although this is not likely) and all it cost the client was transaction costs and taxes on the gain. Does this make any sense? Think of it this way: the money manager is happy (he’s charging fees), the consultant is happy (he’s charging fees) and the broker is happy (he’s charging commissions). And the client... well three out of four ain’t bad.

1 A call option gives the issuer the right to “call” the security (in this example mortgages) back from the buyer/holder. If interest rates move higher, you can bet these bonds will not be called. Why would the issuer want to call back lower interest payments and replace them with higher payments? If interest rates move lower however, where an owner/holder might potentially profit, the call feature allows the issuer to redeem the instrument, ostensibly to reissue an obligation at a lower rate and thus save the issuer money. From the perspective of the issuer, call features are a “heads I win, tails you lose” proposition. From the perspective of the buyer/holder a call feature is a “lose/lose” proposition. Let the amateur buyer of callable interest bearing instruments beware.
“Index Investing”

Most people would be vastly better off to simply dollar cost average into a low cost index fund and hold it for the long term. Notwithstanding, there are many problems with index investing not the least of which may be the patience required (as explained above) to enjoy the potential benefits. What’s wrong with index fund investing? It is essentially an investment process that does not permit thinking. If this sounds somewhat harsh and extreme then answer these two questions: Who were the biggest buyers of Worldcom, Cisco, Yahoo!, Enron and AOL (to mention just a few) right up to the market top? And, who can never hold cash? The answers: index fund managers and index fund managers. I could rest my case, but I will continue.

Now consider the mechanics of index investing. With only a few exceptions, most indices are market capitalization weighted. The implications of market capitalization are the larger the stock the more the index manager is required to own. Here’s why. As a price of a stock climbs, the market capitalization also climbs requiring index funds to buy more of the advancing stocks. In short order index investing increasingly mimics momentum investing (the practice of buying what is going up just because it is going up or selling what is going down simply because it’s declining.) Some have even argued, although I believe it is farfetched, that the S&P 500, perhaps the most popular of the indices, was what created the bubble. While I do not believe it created the bubble, it certainly contributed to the bubble in no small measure.

In addition, the imbedded capital gains of many index funds represent a fascinating, but very real risk. If an index fund is declining and investors are exiting, at some point low basis stock may have to be sold to redeem the shares of departing investors. So the buyers of an index fund, who are late in the game, may experience paying a tax on portfolio gains even though they have lost money! So much for those who extol the virtues of tax efficient index funds.

“Good Companies = Good Stocks”

It is universally believed that one of the keys to entering the nearly gates of investing heaven is to buy good companies. It sounds so logical, if not obvious. But I would argue that buying superb companies at the wrong price — paying $2.00 for $1.00 of value — is no better than buying bad companies. Cisco was, and is still, a great company. But the folks who paid $60 or $70 at the peak made a financially serious mistake and cannot possibly be happy. Yahoo! also seems to be a well managed company with a clean balance sheet — but paying 100 times earnings is simply not safe.

Interestingly, if one could purchase the stock of even a horrible company at a price reflecting a discount to the cash on its balance sheet, one could simply liquidate the company, pay off its creditors, and walk home with a profit. So it is possible to invest in a horrible company, where it’s stock is trading below it’s cash, and still have a safe, high return potential investment.

Those who champion the Efficient Market Hypothesis (EMH) will tell you it is not possible to find companies where the stock is selling at a discount to it’s cash — and we’re happy to nod in agreement with these folks as we continue to seek these kinds of compelling opportunities. Warren Buffett, a former virtuoso of unearthing companies selling for discounts to cash, defended this practice “cigar butt investing” — the metaphorical practice of picking up cigar butts in the gutter for a few of it’s last good puffs.

(Have you heard about the two professors discussing the virtues of Modern Portfolio Theory while walking to class together? It seems one of the professors stopped mid-sentence as he spied a $100 bill lying at his feet. About to reach down to retrieve the money the second professor chided the first professor as he was bending over, explaining, “If it was really a $100 bill someone would have picked it up already.” The first professor nodded in agreement and dismissed his foolishness, left the money on the ground, and scurried off to his students.)

“Risk vs. Safety”

There is nothing more absurd than the notion that risk equals volatility. If you have been reading Commentary for any period of time you know how irrational this investment maxim is. Bob and I define risk as the probability of impairing our capital. Period.

We believe safety rests in the absence, or at least mitigation, of those elements that may impair our capital. As such, safety can be defined by the financial strength of an enterprise. Whether a company is safe is mostly influenced by the quality of its assets and the amount of debt secured to fund these assets. Safety has nothing to do with stock price variability.

Bob and I talk about the three prerequisite pillars fostering personal financial integrity: 1. high quality assets; 2. adequate liquidity to meet all near and intermediate term cash requirements (we define intermediate term as three to five years); and 3. little or no debt. It’s really no different for a business. Safety is determined by solvency (the ability to pay bills) and the enterprise’s ability to service it’s debt. Enterprise value is created by the ability to generate profits and free cash flow. Find a profitable business, with excess cash flow (preferably reliable excess cash flow) supported by high quality assets with little or no debt and you may have found a success story waiting to happen.

In the 1934 edition of Security Analysis, by Graham and Dodd, Dr. Benjamin Graham had this to say about safety, “An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative.”

Dr. Graham additionally asserts (also from the 1934 edition of Security Analysis) that stocks have prices; businesses have value. Speculators base their “standards of value upon market price.” Investors judge “the market price by established standards of value.” (Please read this paragraph as many times as is necessary to indelibly imprint Dr. Graham’s remark in your consciousness. Truly successful investors have internalized this principle.)
In Summary

Given that most investors – including "professionals" – attain investment returns inferior to the S&P 500, and with considerable potential to impair capital, the discerning prospective client logically inquires "Why should I entrust my financial future, to you?" Excellent question.

From the perspective of these two simple bumpkins in Los Altos, we believe there are only two styles of investing: value and overvalued. I repeat: there are only two styles of investing: value and overvalued.

I know, it sounds too simple. Think about it. If a “growth” investor doesn’t seek to understand the value of what they are buying, then what are they doing? Any intelligent investor would prefer to own the stocks of companies that are profitable, and growing – and the more rapidly they are growing, the better. But at what price? Where is our margin of safety?

Imagine we were to have purchased a wonderful small company that was growing at such an above average rate it no longer qualified as “small cap”. Are we to sell it just because it may now be considered mid cap? What if the prospects of this company continue to improve and it is a better value today, at a higher price, than when we originally purchased it while it was considered a "small cap" stock? Should we buy more at a higher price, or sell it because it is growing? These are not academic questions. Answering these, and similar, questions correctly will provide the foundation for investment success.

The two most common questions Bob and I are asked regarding prospective new clients are, "Are we still accepting new clients?" and "What is the best way to introduce a prospective client to our office?" As with all healthy, growing businesses, we are still accepting new clients. Our target is one new client a month. At this relatively low rate, we find we can continue to service the needs of our existing clientele and maintain a healthy business. We expect to be able to grow at this pace well into the foreseeable future.

We have found the best way to introduce someone to our services is to send the prospective client a copy of our multimedia CD “The Family of Affluence.” Feel free to pass along your copy; if you prefer, you can call the office and provide us with contact information. We will mail the CD with a cover letter introducing ourselves, our "Description of Services" and a recent edition of Commentary. We also provide prospective clients with a one year complimentary subscription to Commentary. I will personally call the prospective client about one week later to answer any questions they may have.

Bob and I sincerely thank you for your support. Since our inception in 1989 Sullivan & Serwitz has grown exclusively through referrals. Your referrals are the best acknowledgement we can receive, letting us know we are doing a good job. Thank you.

Messrs. Kahn, Lushbough and Robotti could not care less about style boxes and all the other nonsense of MPT and EMH. They will look anywhere, and buy anything, that makes sense: that which is safe and cheap, and offers a reasonable potential for return. Their agenda is to simply accumulate the stock of companies trading at a meaningful discount from their appraisal of intrinsic value. It is so simple. One would think even investment consultants could grasp it.

Working hard for you.

Marshall Serwitz

P.S. Thank you for your support.

P.P.S. Tax Season Reminder: For all clients who prepare their own tax return, or have a tax preparer, please remember: 1. Please send a copy to our office for us to review. 2. Our fees may be tax deductible.

Teaching and Lecture Activities

We have developed presentations for the following organizations: various county medical associations, medical conferences, and hospitals throughout California, California Society of Certified Public Accountants, Tri Valley Business and Estate Planning Council, California State Medical Society, Minnesota Mining & Manufacturing (3M), U.S. General Accounting Office (GAO), the Palo Alto Police Department, and many other organizations. Teaching and lecture activities are tailored to the group. Some of these courses have provided CPE credit. If you would like to arrange a seminar please contact the office.

SULLIVAN & SERWITZ offers a multi-disciplinary approach to providing investment and financial counsel to its affluent clientele. Modeled after a traditional Family Office, we assist clients in the strategic integration of investment, estate, and retirement planning as well as asset protection techniques.

Serving a broad cross section of affluent families, our practice is small by design. We believe Sullivan & Serwitz has one of the lowest client-to-principal and client-to-staff ratios in the wealth management profession. We are committed to maintaining the highest quality services through the controlled growth of our boutique practice, preserving the principal-to-principal relationships we enjoy with our clients. A complimentary introductory meeting is offered to all prospective clients meeting our minimum investment account of $3,000,000.