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Quarterly Investment Outlook

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Old School Techniques for New School Investing

In hindsight, we think it's fair to say that the contraction in stock prices, following the painful end of "irrational exuberance" in 2000, triggered a major leap forward in the pace of evolution of the equities markets. The emergence of the global economy and the growth of foreign equities markets accelerated at the same time investors turned away from large-cap US domestic growth stocks out of fear or in pursuit of better returns elsewhere. Today, a scant five years after the bubble burst, there is a vast number of investment opportunities available to investors who have access to the same information, tools, and technology used by professional investors. Where the "science" of investing is concerned, the lines have been blurred between amateur and professional investors. However, they still remain drawn when it comes to the art and discipline of making investment decisions. Why is that? Will that always be the case? And what does this ongoing transformation mean for investors?

Paradigm: A model or framework forming the basis of a methodology or theory.

It seems that during the last decade, the phrase "new paradigm" has popped up with increasing frequency in discussions regarding the capital markets. So frequently, in fact, that it moves us to question whether it can be used at all to describe what has become a model where the only constant is change. The fluidity of the investing landscape, marked by a dramatic transformation of the global economy and the underpinnings of the capital markets, presents investors with more information and opportunities than they could have imagined in 1985, at the dawn of the Technology Revolution.

In the last 20 years, the infrastructure of global capital markets has evolved at an accelerating rate. The great leap forward in Technology spawned improvements and innovation in communications and data processing that compressed time and distance. This led directly to the emergence of what today is a fully engaged global economy, one very different from the US-centric model that dominated during most of the 20th century. As one might expect, this change is reflected in the capital markets. For decades, information and access were the "goods" offered for sale to the public by the investment community in exchange for fees and commissions. Technology changed all that. Today, the Internet and discount brokerage have made information and access available to investors to a degree commensurate with what they're willing to pay. A large number of information resources and analytical tools, once available only to the pros, are surprisingly affordable and accessible to self-directed investors. So, one might assume that "smarter" investors with more choices might improve upon past performance.

KISS: A Dying Concept

"Keep it Simple Stupid" is a philosophy that has served many well throughout the ages. It's worked for stock market investors too. They researched companies or relied on the advice of others and put them away in portfolios, revisiting them when the market went south or when the company made headlines. For the most part, those that bought quality companies did well through their benign neglect over the "long-term", an indeterminate period of anywhere between one and thirty years depending on when they needed to spend their money. Today, another old standard, "Nothing Lasts Forever", applies when talking about the capital markets.

In 1970, investors could choose from about 1500 publicly traded companies on the NYSE and OTC, a few mutual funds, a handful of commodities futures and three or four major indices to use as benchmarks. With so few alternatives, a Bottom-up, Buy and Hold strategy was the only strategy when it came to stocks. Today, it's one of many strategies, some simple, many more convoluted. The global securities market is comprised of more than 10,000 public companies traded on numerous exchanges and ECNs (Electronic Communications Network), more than 15,000 mutual funds, 8,000 hedge funds, hundreds of options and futures and a dozens of benchmark indexes to choose from. Information is disseminated in an instant and trading is frictionless and inexpensive. Markets react to news from anywhere in the world within seconds as opposed to hours (sometimes a day or two in 1970). Long-run market conditions are now often measured in months rather than years and some investors' return horizons vary with the seasons. Technology-driven gains in efficiency and productivity, coupled with an exponentially growing number of investment vehicles, have infused the capital markets with such complexity that KISS has been banished altogether from the vernacular of investing. It's not your father's stock market.

Old School, New School

New School is in. Vast amounts of information and easy access to the tools that comprise the "science" of investing have resulted in "smarter' or at least better-informed, self-directed investors who either pick stocks or allocate pooled investments. With so many choices available, it's tempting to pursue returns wherever and whenever something "looks good". That may work for a hedge fund manager with a buy/sell discipline but for most investors this has meant tiring of what hasn't met expectations in the short-term, buying something that's already appreciated significantly, and abandoning their original strategy while eschewing any assessment of risk. This goes a long way toward explaining why the average mutual fund investor earns a return approximately half that of the average mutual fund! It's not because there are too many choices, it's because many investors simply don't do the work or apply the discipline required to successfully manage an investment program in changing market conditions. It's proven time and again how difficult it is for investors to trade in their emotions for objectivity when it comes to their own money. Those that can have a running start on a successful investment program.

With the choices available today, it's easy to diversify a portfolio across asset classes, capitalizations, industry sectors, and geographical boundaries. But how should one approach that and once it's done, what happens next? Many investors have gained some experience from investing their 401k plans. Acknowledging that little time will be spent monitoring and rebalancing, most employ a Strategic Allocation of their non-retirement assets across a broad mix of investments that encompass just about everything out there. This is done after establishing a level of risk tolerance for themselves that will remain fairly constant over the long run. This approach requires infrequent rebalancing since it's designed to capitalize on long-run market conditions. A second approach is for those who want to drive 10-20 miles over the speed limit. These investors make predictions about the future relative performance of all the choices they have before them and use Tactical Allocation to make bets as to where they might capture the best performance. This strategy requires routine monitoring and more frequent rebalancing. Naturally, this investor's risk tolerance level varies with changes in market conditions. Many non-professional investors attempt this without success, often succumbing to the same temptation of mutual fund investors who adjust their allocation while looking in the rear view mirror. It's a simple fact, making investment decisions, regardless of how much analytical "science" is employed, still requires an investor to make predictions, some might call them guesses, about the capital markets and their portfolio.

That's why we believe the Old School tasks that make up the art and discipline of making investment decisions are still critical to investment success. Things like: Connecting spending objectives to an investment strategy; Measuring the risk associated with pursuing a return; Allocating capital among asset classes to profit from normally recurring, rather than anomalous market conditions; Making predictive rather than reactionary investment decisions based on sound analysis; Valuing a company's stock in relation to its financial performance; Prudently rebalancing when market conditions dictate; Taking time to routinely, rather than anecdotally, review results and revisit objectives; Most importantly, and where the self-directed investor fails time and again, defining and measuring investment success over a meaningful period of time. Will New School techniques render these immaterial to the process someday? We don't think so. In fact, we think they'll be of greater importance as the complexity of capital markets increases with the times. Unfortunately, it may take another hard lesson like 2000-2002 for a number of investors to reach that same conclusion. The challenge for investors in this environment is to pursue the opportunities presented in New School capital markets by using Old School practices. Those that do will be rewarded. For those that don't? They can look forward to joining the average mutual fund investor in obtaining below average returns.

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