

October 5, 2009

Dear friends,

Greetings. What a difference six months make. Rarely has the often overused stock market to roller coaster analogy been more fitting. Let's look at a couple of hypotheticals. Say we had invested \$100,000 in the entire U.S. stock market on September 1, 2008. A mere six months later this investment would have dwindled to a value of just \$57,372. But if we had invested another \$100,000 the next day, March 1st and waited another six months, it would have been worth \$147,766. Hooray! Two diametrically opposite **short-term** investment experiences. Now let's put these consecutive time frames together and analyze. \$100,000 invested continually from September 1, 2008 all the way through to September 30, 2009, through the depths of despair, and then into a powerful recovery, would end up being worth \$84,777, down about 15%, well within a normal volatility range for any historical thirteen month period.

Now as a practical matter for us the above illustration is unrealistic because it assumes a portfolio comprised of 100% stocks when our portfolios usually have aggregate positions roughly in the 45% to 60% range. For simplicity sake, if we assume a 50% commitment to stocks, then the above numbers would all roughly be cut in half resulting in a total thirteen month period loss of approximately 7%. Reason to rejoice? Perhaps not but certainly not reason for despair either.

Now let's introduce one last hypothetical. Suppose we had exited the stock market entirely when it hit bottom, for this cycle, in March. We claimed we were not giving up on stocks forever but we just needed to take a time-out to let things stabilize. I know you didn't do this (albeit it wasn't easy) but many of your friends might have. For me, this is where it gets really scary and would definitely cause sleepless nights. Using the 50/50 mix cited earlier our original \$100,000 would have stopped blood letting somewhere around \$78,000. Since it would now be in all cash it would have earned next to nothing, but let's call it \$79,000.

Okay, so here we are with \$79,000. What's our next move? Get back in even though the market has been surging recently? Isn't that buying high? Over the short-term it sure is. But after a 50% sprint up in stocks of late isn't it entirely possible that the market pulls back a little if for no other reason than to take a breather? Maybe. Maybe not. I don't know. So should we continue to remain on the sidelines in case that pullback does happen? Back in the market or stay out, what to do? Only one thing is for sure here; we are now practicing some sort of full-blown market-timing strategy where the only way to succeed is to be lucky not once but twice.

Now an interesting and curious thing here is that the very same investor who exited the stock market at a relatively low point last March now may be waiting for another relative low point to get back in. That takes way too much mental manipulation for me to understand. Let's keep it as simple as we can. Our odds of success are much better if we only have to be right one time during our investing career and not twice every time popular and collective sentiment about the future fates of financial markets change. The truly scary option is relying on our ability to continually and consistently outthink market movements. To succeed, we must allow markets to deliver the long-term commensurate amount of return for each increment of short-term risk we are willing to accept and tolerate. It's not always easy, but it is always smart.

Be well,

