

September 28, 2005

Dear clients,

Greetings once again! In last quarter's letter I wrote a line about investing that read "***Some risk/volatility is appropriate, and actually welcome ...***" This quarter I thought I would explain specifically why certain risk is good for your portfolios. I think you will find my explanation fairly common sensical but the concept is so critical to successful investing that I don't want to leave anything to chance or subject to misunderstanding or misinterpretation. Here goes:

The risk/reward tradeoff is here to stay. In a nutshell this simply means that a prudent, well-informed investor, will always require a level of investment return that is commensurate with the level of risk assumed. Let me explain by example. Say you had \$100,000 to invest and your choices were to either buy a long-term U.S. treasury bond, currently yielding approximately 4.5%, or to invest in some form of stock mutual fund with no guaranteed rate of return at all. There would be no rational reason to even think about investing in the stock mutual fund unless you expected to earn a return greater than the risk-free treasury rate of 4.5%. Here's where it gets interesting ...

Although the stock market's long-term average return is a little over 10% per year, there are very few years when the actual return is even close to this (only three years in the last fifteen for example for the S&P 500 index). Usually the market's actual annual return is either much higher or lower than its long-term average. But let's suppose for a second that there was no volatility in the overall stock market and that the rate of return was fixed at 10% every year. One of the first questions that should come to mind is "Who in their right minds then would invest in a U.S. treasury bond if they could receive more than twice the rate of return by investing in the stock market?" The answer, **no one!!** So obviously there must be compelling reasons why there are trillions of dollars of U.S treasury debt outstanding.

The fact is stock markets are volatile and in the short-term very unpredictable. Some individuals and institutions simply cannot or are not allowed to invest in instruments without a fixed rate of return. Let's face it, it's not always emotionally easy to earn that 10% average return. Great perseverance and time can be required. ***Down periods in the market can be very unsettling but the fear and nervousness they create, are actually blessings in disguise for if stock markets didn't periodically and unpredictably drop in value, there would be no rational reason to expect a return that would be any greater than a treasury or bank account's return.*** It is the "real return" (total return less inflation) differential between treasuries and stocks that makes long-term stock market investing so appealing and necessary for most. For example, using the above returns and assuming inflation at 3%, treasury bond real returns are 1.5% while stock's real returns are 7%, or more than four times greater.

So now let's review why risk and volatility is actually a great friend of the intelligent investor and should be embraced instead of feared. If long-term stock and treasury returns were the same, our entire economic system could not function. There would be no financial incentive for investors to risk precious capital in entrepreneurial endeavors, that might fail, if they could achieve the same rate of return by simply parking their money in the bank or treasuries. And without capital markets, we have no economy, and you as intelligent investors do not reap the significant benefits of this real return differential. You see, taking appropriate levels of risk within your portfolios actually pays off mightily! So the next time you see a quarterly or annual loss on your investment statement (which you will I promise) it may be unrealistic to ask you to jump for joy but I implore you not to be disheartened or discouraged either. It's all part of the deal. As always, thank you for the trust and confidence you continue to place in me!

Regards and best wishes,

