What’s Correct?

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Stock prices have fallen recently and the Press has had a lot to say about it, yet we wonder how much their words and speculation add to our understanding of what is happening. We see reporters attempting to explain the present, invite readers to fear the future, and encourage investors to take action. Permit us to share information that allows us to remain calm and optimistic in the face of all this speculation.

The media have many pressures in their reporting. They only have a small amount of time or column space in which to explain complex phenomena. This creates a tendency to focus on one reason for market declines. Yet in truth, no one variable fully explains market movements.

Reporters also sensationalize the news to seduce their audience. This creates a pall of gloom: If it bleeds, it leads. Perhaps most importantly, a primary source of writers’ information on the markets is the brokerage community. Brokers and media have an interest in selling – writers to sell papers; brokers to sell/trade stocks. Below are some ways the tendencies of the press influence the news:

We are in a market correction.

“Market correction” is a misnomer (and a gloomy one) for two reasons. The trend of stock markets over time has been to increase in value. It would be more appropriate to report a “market correction” when stock prices rise. Yet irrespective of market movements, stock prices are always correct because they instantly reflect a consensus of all the information and emotions related to those prices.

Things have been really risky in the market lately due to sub-prime mortgage problems.

The market is always risky. And yes, the sub-prime mortgage world is now paying for the manner in which it compromised its lending disciplines. This is what the press has been focusing on in their quest for a single reason for the decline that emphasizes the most fearful aspect of this situation. The sub-prime world is inherently risky but it is not reflective of the risk of stocks in general. A few months ago, the media were correlating stock market movements with oil prices as the reason for market ups and downs. A new day, a different “reason du jour.”

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Market declines are due to selling pressures.
This is another attempt to provide a single explanation for the market decline. This explanation makes no sense because in order for a trade to occur, a seller and a buyer must agree on a price. Also, as much “selling pressure” as there is now, there is significant “buying pressure” on hedge funds and private equity groups with gobs of clients’ cash still (unsuccessfully) trying to outperform the market.

Market declines are due to a credit squeeze.
The credit squeeze does make it harder to obtain loans and therefore it has become more costly to borrow money. This could cause stock prices to decline. But this is only one of the many factors causing their decrease. And that only explains what has happened – not will happen.

Stocks are too risky to really be a good investment.
The press usually offers reasons not to own stocks. A headline this month announced: “Stocks Waver as Uncertainty Remains.” Stocks will always waver because uncertainty will never disappear. That uncertainty (risk) is what creates the return to investors. Here’s an historical perspective on relevant asset class returns:

![Annual Compound Returns: 1927 -2006](chart)

Stocks offer more attractive returns than bonds over the long-run because they’re riskier. Why have small value stocks enjoyed the highest historical return of all asset classes listed above? Because they’re the riskiest asset class.

The investment plans we create for clients promotes the discipline of prudent investing that allows us to ignore the media’s banter. Warren Buffett put it a bit more bluntly: “Let blockheads read what blockheads wrote.” We do not feel concerned about the decline in the market, nor about what we are exposed to through what the investor does to the investments. We structure an investment plan for you that addresses your appetite for risk and aligns it with the returns necessary to achieve what you value. We realize that due to market volatility, markets decline. Studies have shown that over the past 100 years the stock market has averaged a decline of 10% or more each year and dropped 20% or more every three or four years.

Yet investors who embrace markets as owners (not traders) ultimately are rewarded. Those rewards tend to be delivered in concentrated and random bursts. If you market time and are out of the market you risk missing those bursts. Time in the market, not market timing, adds value. Another study concluded that 10 trading days accounted for over 60% of the S&P 500 returns over the past 50 years. It’s no wonder that Warren Buffett recommends to “Only buy something that you’d be perfectly happy to hold if the market shut down for 5 years.”

In order to maximize the benefits of your asset allocation decision and the long-term success of your investment plan, it’s vital that we continue to adhere to a strict discipline of buy-and-hold investing in which only two factors influence a change in your current asset mix:

1. Periodic rebalancing to your target allocation. This is very different from market timing, which attempts to predict future market movements by moving away from your established target asset mix. Rebalancing maintains acceptable risk characteristics of the portfolio with the added benefit of a disciplined “buy low, sell high” methodology.

Rebalancing also maintains the stock/bond ratio. This insures that profits are taken from the stock side during strong up markets to maintain the short-term bond allocation for periods of inevitable stock market declines. For investors making regular withdrawals, this allows funds to be taken from stocks during good markets and from the short-term bond portion of the portfolio during down markets.

2. A significant change in your financial circumstances. The most common and expected change is retirement. Other changes that can occur are medical emergencies, work disabilities, family problems, and other unforeseen difficulties that may require altering your investment plan allocation. In all cases we strive to maintain a balance between the need for withdrawals and the need to maintain a certain level of growth in the portfolio.

Adhering to these two factors changes the emphasis of your investing decisions. Rather than reacting to the breaks in the waves, a buy-and-hold strategy focuses on the deeper waters underneath and allows you to embrace the important and enduring trends in your life – and in the market.

Our investment process acknowledges that stock-specific movements of individual stocks are not predictable and that a diversified portfolio is the antidote for neutralizing the impact of those gyrating stocks. Investors heavily weighted to companies that tried adding value through the sub-prime market now wish they were more diversified – a wish no doubt shared by traders in tech stocks in the late ‘90s and my Dutch ancestors holding tulips in early 1637.