► **Greycourt White Paper**

White Paper No. 13 – *Recent Events: The Long-Term Investment Implications*

Background

Although the terrible events of September 11 are still fresh in our minds, it is not too soon to consider what the implications of those events – and, indeed, the stock market meltdown that has occurred over the past eighteen months – might be.

Discussion

Whenever equity market performance is especially bad there is an understandable tendency for investors to lose perspective. Our pessimism tends to be even more pronounced when social or political upheaval accompanies the market turmoil. But while positive or negative price momentum is common in equity markets and social and political turbulence is an inevitable part of the human experience, time smoothes out these exceptional periods, leaving in place the eternal verity that, over the long term, there is and must be a positive and generally predictable relationship between risk and return in our investment activities.

Stepping back from the fear generated by terrorist attacks, wilting economies and declining markets, we suggest that the following market principles remain intact and should be kept firmly in mind by investors who hope to achieve long-term success.

Outsized returns imply outsized risks

The US equity market returns generated throughout most of the 1990s led many investors to believe that the risk of investing in equities was far lower than had been believed. Otherwise sensible people wrote books advocating 100% equity portfolios or arguing that the Dow would soon reach astronomical figures. In fact, as equity prices rise, the risk of owning those securities also rises: prices move to – and then far beyond – fair value. The inevitable result is serious price collapse, with the stocks that inflated the most falling the most. Peak to trough (that is, what currently passes for the trough), US Blue Chip stocks are down roughly 30%. Peak to trough, the NASDAQ has experienced the worst performance of any asset class since the Depression. Peak to trough, the dot.coms have virtually disappeared. *Lesson*: Establish reasonable allocations to asset classes and market sectors, with sensible bands above and below your target allocations. As price rises move your allocations outside those bands, take enough of your winnings off the table to move the allocations back within bounds. Outsized allocations very substantially increase the risks of investment portfolios.

What matters the most: asset allocation, taxes, fees and trading costs

The most important determinant of investment success is getting the asset allocation decision right. If you expose yourself to more risk than you can stand, you will bail out of every market at the bottom and buy back in at the top. If you expose yourself to less risk than you can stand, your gains will be a lot smaller than they should be. The next most important matter for a taxable investor is managing income and capital gains taxes. Like it or not, Uncle Sam (and Governor Bill) are your partners. Aggressively harvesting losses, managing tax lots, controlling turnover and holding periods and working with tax-aware managers will add meaningfully to your net wealth, even if your gross investment returns are only average. Finally, sensible investors optimize their money management fees and control their trading costs – not just commissions, but spreads and market impact. *Lesson*: Any investor with a modicum of time and sense (or a good advisor) can manage asset allocation, taxes and investment fees and costs. If you can do that, you can make a lot of other mistakes and still remain well afloat.

Money managers matter less than you think

Many investors think that the secret to investment success is finding the best money managers. During most of the 1990s that meant finding growth, tech and momentum managers. But there are insuperable problems with this approach. The fact that a money manager has recently outperformed the market says almost nothing about whether that outperformance will continue. The hottest growth, tech and momentum managers of the 1990s are virtually shunned today, and in any event you could have achieved the same performance by buying a growth or tech index fund. Evaluating a money manager, it turns out, is a far more qualitative than a quantitative process. Another issue is that money management talent matters more in some sectors than in others. Exhibit A illustrates the relative importance of active money management in various asset classes. From cash through US large cap stocks, markets are so efficient that even the best managers will have extreme difficulty maintaining an advantage over other managers or, net of all costs, over the benchmark. In these sectors what is important is controlling investment costs, fees and taxes. But as market sectors become less and less efficient – that is, when information becomes more and more difficult to come by – talented managers have room to run. In fact, in some asset classes, such as private equity, the markets are so inefficient that picking the right manager is the entire ballgame. If you are invested with top quartile managers you will be successful. If you are invested with second quartile PE managers you will only roughly achieve returns commensurate with the risk (including liquidity risk) you are taking. If you are invested with third or fourth quartile managers you should have left your money under the mattress. *Lesson*: We should all be looking to invest with the best managers, but finding them is far more difficult than simply looking at their returns. Focus your manager searches on sectors of the markets where a good manager can make a difference, and even then keep firmly in mind that the money management industry produces lots of young geniuses, but few old geniuses.

Diversification is essential to investment success

During much of the 1990s, when megacap growth stocks were returning 25% or 30% per year, diversification had few fans. Investors whose portfolios were loaded up with Lucent, Cisco and Nortel gazed with pity on their well-diversified friends. Asset allocation mutual funds bled assets as investors flocked to Janus , PBHG and similar growth and momentum fund families. Value managers retired from the field in disgrace and some of the world's largest financial firms opined that international investing was a quaint relic of less sophisticated times. Bond allocations fell to infinitesimal levels and dot.com jillionaires grew like mushrooms. But what a difference a millennium makes! Today, value managers are heroes, Janus and PBHG are on the rocks, bonds – even at ludicrously low yields – are prized by everyone, and, as for Lucent, Cisco, Nortel and the dot.coms, well, the less said the better. *Lesson*: Diversification always matters. Simple mathematics tells us that, as investors, we need to avoid massive losses if we hope to create wealth. A portfolio that declines 50% must double just to get even. Tech stock portfolios that lost 90% of their value must appreciate 1,000% to get back to even capital – something that won't happen in our lifetimes. A well-diversified portfolio will never shoot the lights out, but neither will it shoot its owner.

Momentum is not your friend

Markets demonstrate momentum – upward and downward – not because the markets themselves are inefficient but because people are imperfect. Rising markets cause us to become overly enthusiastic and to believe we are smarter investors than we are. Falling markets cause us so much distress that we come to believe we know nothing about investing. It is euphoria and despair that cause markets to over and under-shoot fair value, sometimes very substantially. *Lesson*: Historic price/earnings ratios may be imperfect guides to equity pricing, but they are far better guides than our own emotions. Wise investors become cautious when P/Es rise substantially above historic averages and become aggressive when they fall well below those averages. In-between, wise investors remain patient.

There are no "new paradigms"

Whenever any sector of the market achieves valuations that simply can't be explained by traditional valuation methods, we are likely to be told that the old rules don't matter because there is a "new paradigm." The new paradigm might be that what matters is not profitability but market share and "eyeballs." (Or, in a much earlier age, what mattered was not profitability but rights-of-way and miles of laid track.) But new paradigms come go, while profitability is always with us. Remember the "Nifty Fifty," and the "One Decision" stocks of the late 1960s. Remember the glory days of Gerry Tsai and the "Gunslingers." Remember when Julian Robertson could do no wrong. The new paradigm investors of those days got killed just as dead as the new paradigm investors of the dot.com era. *Lesson*: There truly are no new paradigms. Investors buy stocks in companies solely because those companies are profitably pursuing sustainable business models and will begin to distribute those profits out in dividends or via stock buybacks. If we buy a stock for any other reason we are engaging in behavior more appropriate to Las Vegas than Wall Street. Dot.coms, tech stocks, Nifty Fiftys, One Decision stocks and soaring macro hedge funds can float on hot air for awhile, but not forever; you can't fool all of the people all of the time.

Investing is a global activity

The remarkable restructuring that occurred in American industry between the dismal 1970s and the heady 1990s, the collapse of Communism and the worldwide victory of free market democracy, and the extraordinary pace of technological change driven by American companies that didn't even exist two decades ago – these and similar factors led America to astonish the world with the vigor of its economic engine during the 1990s. Who could remember the grim days when the Soviet Union was going to "bury" us, when the stunning post-war success of Japan and Germany obsoleted much of American industry? Well, we can. And, in fact, while it's certainly true that the S&P 500 clobbered the international indices during the 1990s, ten years does not an investment lifetime make. The EAFE beat the S&P in the 1970s and again in the 1980s, and as of this writing remains ahead of the U.S. markets for the past thirty years. *Lesson*: Investing is not a chauvinistic enterprise. Instead, it requires investors to seek out value on a global basis. And this doesn't mean buying ADRs in multinational companies that happen to be domesticated abroad (and whose performance is almost perfectly correlated with multinational companies that happen to be domesticated in the U.S.). It means seeking out companies whose fortunes are intimately connected with economies that are developing at different rates and are at different developmental stages than our own. Adding a solid dollop of international stocks to a U.S. domestic equity portfolio simultaneously increases return and decreases risk, and that's as good as it gets in this imperfect world.

Summary

Sound investment principles don't change merely because the markets are roaring upward or collapsing around our ears. Nor, short of the collapse of Western Civilization, do sound investment principles change because of political or social turmoil. The principles remain sound at all times and under all conditions – it's just that it's much more difficult to remember them at some times than at others.

We will be happy to discuss the principles in this paper with you.

GREYCOURT & CO., INC.
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(This paper was written by Gregory Curtis, Greycourt's Chairman.)