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H. Bradlee Perry
Marble Harbor Investment Counsel Advisory Board Member
Investment Consultant

Investment Wisdom Persists

It's no surprise that investment wisdom expressed over the years persists indefinitely; but too often in the hustle and bustle of daily stock market trading and the continual flood of new "news," it's forgotten or consciously ignored. So the summer's supposedly lazy days are a good time to review some of the wise ideas expressed in the past by sensible, experienced investors. Many of these people's names have long since been forgotten, but their wisdom lives on. Let's look at some of their ideas.

Predictables And Unpredictables

First is a simple – and obvious when you think about it – concept first presented by David Babson some fifty years ago: Make investment decisions based on predictable factors, not unpredictable ones. Discussing this, he showed two lists. First,

The Perennial Unpredictables

1. What stock prices will do next week, next month or next year.
2. Which way the political winds will blow.
3. When the economy will change direction and for how long.
4. Where the course of international developments will lead.

The folly of trying to predict stock moves should be obvious to everyone, but not a week passes that I don't read or hear a forecast for stocks from some self-assured guru. Many investors base their decisions on such guesses. And that's all they are because in the short and intermediate terms, stock prices (both individually and overall) respond primarily to human emotions, which certainly are totally unpredictable. On the other hand, in the long run stock prices are driven solely by secular earnings growth trends.

At this point I can't help but nominate a notable stock market prediction for the All-Time Boo-Boo of the 20th Century. By August 2, 1982, after a painful decade and a half of no net gain in the stock market, there had been a nice little rally of 10% in June and July that year that boosted the Dow Jones Average to 850. That was still below the previous high of 1000, but certainly it was a welcome development after a long, gloomy period. However, on August 2 one of Wall Street's leading "market strategists" headlined his weekly report: "The Summer Rally is Over."

Ouch! The next day, August 3, a big upsurge touched off the greatest bull market in history. In the next five months, the Dow jumped over 20% to a new all-time high. But most notably, over the next 25 years, with a few brief interruptions along the way, it rose eighteen times, to a record peak of 14,200 in October 2007. And even with its recent gyrations, the Dow stands today at fourteen times the low levels at which this crystal ball-gazer made his fateful judgment.

Presumably this man has some intelligence, but his woeful call in 1982 shows the foolishness of trying to predict the unpredictable. Investors who followed his advice and retreated from the market at that crucial point lost lots of money even if he later induced them back into stocks partway through the market's subsequent huge advance.

Similarly, political trends, economic shifts, and international developments are often unpredictable. For example, who forecast just two years ago that a grass roots movement of ordinary people, not knowledgeable experts, would spark a powerful political effort to finally address the horrendous federal budget deficit problem? Or who in early 2007 was predicting the biggest financial crisis and deepest recession in 75 years?

Or who several years ago had any inkling that the U.S. would lose so much international influence that it could not force or persuade China to stop rigging its currency at unfair, artificial levels to stimulate its exports, thereby hurting its trading partners, notably America? In the same vein, who would have anticipated that the U.S. would be relegated to a minor, back-seat role in the effort to depose Muammar Gaddafi in Libya?

Now look at Mr. Babson's predictables.

The Predictables

1. The population and labor force will continue to grow.
2. More people will need more goods and services.
3. Research will develop new products and new techniques, creating more jobs, greater productivity and higher demand.
4. The dollar's buying power will keep shrinking.
5. Well-managed companies with favorable long-term characteristics will continue to make above-average progress in earnings and dividends.

Because of the fundamental changes in basic economic forces, which I've discussed in recent *Ruminations*, the favorable impact of numbers 1, 2, and 3 have clearly diminished over the past decade, but they're still positive forces. On number 4, inflation has slowed but it is still present and it could re-accelerate in the future. Number 5 retains its validity and is even more important in the difficult economic environment of today and most likely tomorrow.

To be sensible, investors must base their decisions 100% on predictable factors, and avoid the trap of relying on unpredictables. Two other wise men have expressed this point well.

Harvard economist John Kenneth Galbraith: "We have two kinds of forecasters, those who don't know and those who know they don't know."

And the pithy Mark Twain: "It ain't what you don't know that gets you in trouble. It's what you know for certain that just ain't true."

Invest in Businesses, Not Stocks

In the long run, most people get rich by building a business – whether it's Bill Hewlett and Dave Packard with Hewlett-Packard, the DuPont family with their great chemical company, the Rockefellers with Standard Oil (now Exxon), or on a micro level, the Roche brothers with their excellent local supermarket chain outside Boston. Most of us have nowhere near the skill to achieve such success, but we can do the same thing on a smaller scale by investing in the shares of well-run, publicly held companies and benefitting from their managements' ability to achieve good profit growth.

Focusing on businesses has the advantage of dealing mainly with predictable factors. Any intelligent, knowledgeable person can analyze the nature of different industries and the position of the leading companies in them – and conclude how likely they are to continue to prosper. That type of analysis is based largely on known facts, not uncertain guesses about the future. Sure, a careful look down the road is needed and unexpected changes can occur in the future, but investors can achieve a pretty good batting average by concentrating on presently-known fundamentals about businesses.

Stocks are very different than businesses. They are just entries in a computer or names on a page whose prices fluctuate, often sharply from minute to minute, day to day, and month to month, as investor psychology changes unpredictably. No worthwhile judgment about a stock can be made without first doing the fundamental analysis of the company underlying it that I just described. And even that won't tell you where the price will go in the short or intermediate term. So people who say, "I like this stock," as if it were a discrete object are just deluding themselves. There may be a few geniuses who can make worthwhile money by highly computerized trading of stocks, or just making supposedly informed guesses, but almost all who zip in and out of stocks trying to catch favorable price moves do not end up wealthy, and some become just plain poor.

Understanding Valuations Is Critical to Success

I can't repeat too often how crucial it is to seek at least reasonable valuations, if not cheap ones, when selecting any investment to buy: particularly stocks, but also bonds, commodities, or anything else. Because investor enthusiasm runs to extremes at times, even the best company can become so highly valued that its stock is certain eventually to perform poorly, perhaps for a long time.

Cisco, the very successful pioneer in computer networking equipment, is a classic example. As the Internet blossomed in the 1990s, this very capable company quickly surged to prominence – becoming the most rewarding investment in the big technology boom. With earnings growing at 40% per year between 1995 and 2000, the stock's price sky-rocketed forty times, from 2 to 80. And simultaneously its price/earnings ratio rose from a realistic 20 to an insane 150! (The long-term average p/e for all stocks has been 15.)

Obviously investors expected the 40% earnings growth rate to continue indefinitely – a mathematical impossibility – and they felt they had to own the best company in technology land, regardless of its valuation. But inevitably, Cisco's growth slowed dramatically, from an unsustainable super-rate to a still-excellent pace of 17% in the next eleven years. Then – watch out – when the technology bubble imploded in 2000, its stock fell a sickening 90%, from 82 to 8. And today, as a decent but more mature, slower growing company, Cisco's shares sell at a price around 16. That puts the stock still down 80% from its 2000 high, and it now has a very reasonable valuation of 13 times current earnings. Meanwhile, today's new crop of exciting technology stocks – in social networking – has taken Cisco's place with sky-high valuations.

Of course, Cisco was an extreme case, but many other good companies have reached excessive valuations at some time in their history and become subsequent big losers for investors for quite a while. We've seen this with health care stocks, energy company shares, and rapidly growing consumer products companies.

The lesson here is clear: It's just as essential to buy any stock at the right price as it is to invest in superior companies.

Appraising valuations is also a valuable process in determining where the overall market stands. That won't tell where it's going in the near future, but it will tell you whether stocks are cheap or expensive. At valuation extremes – such as October 2007 (high) and March 2009 (low) – this can be a helpful way of determining what direction stocks may take in the intermediate future. This can be an indicator, with no timing attached, but certainly not a sure predictor. And of course valuations always define the risk/reward status of stocks, showing whether they are good buys or sells, or something in between.

For example, at the beginning of August 1982, stocks were obviously dirt cheap – selling at 8 times earnings (just over half of the long-term average p/e) and yielding a high 5.5% (versus today's very low 2%). No one knew then when stocks would start to rise, but they were certainly ripe for a big advance. The only surprises were how quickly that started and how far it carried. All they needed was a little improvement in the economy to change investors' gloomy attitude.

High Portfolio Turnover Is Detrimental To Investment Returns

Except for a few geniuses, all history shows that frequent trading hurts returns. Jack Bogle, the brilliant founder of Vanguard, has proven this with several long-term studies demonstrating that low turnover portfolios have way outperformed high-turnover ones. And Mark Hulbert, publisher of reports on the performance of investment letters' recommendations, recently released a study which shows that since the early 1980s two-thirds of all portfolios "managed" by these letters have done worse from year to year than hypothetical portfolios that made no trades at all, but just held all their January 1 investments for the next twelve months. Sitting still fared much better than churning around.

'Nuff said. Trading is hazardous to your investment health – mainly because it is governed almost entirely by unpredictable short-term stock price guesses – rather than by predictable long-term, fundamental business and company factors. Of course, occasional weeding out of under-achievers and adding good new holdings is necessary for any successful portfolio, but not willy-nilly trading.

Conclusion

There's a lot more investment wisdom that can be discussed at a later date. But it's clear from the examples I've cited here that this wisdom has one common element. All of it is based on hard-headed, simple common sense, most of it derived from the experience of history. Where I summer in Down East Maine, the typical compliment the local people pay to one of their acquaintances is not, "He's real smart." Instead they say, "He's doggone sensible." These folks get it. Smart people think they know everything. Sensible people know they don't.

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Marble Harbor Investment Counsel, LLC
101 Federal Street, Suite 2210
Boston, MA 02110
617-956-6710
www.MarbleHarborIC.com