Berkeley Investment Advisors
Real Estate Brokerage/Retirement Planning

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# Investment Newsletter – December 2006

This month we review our investment management performance in 2006. But before we get to that, I want to share my thoughts on the sources of risk and their implications for investors.

## The Relationship of Risk to Investment Time Horizon

Security prices are determined second by second during the trading day in the U.S. by the traders acting at that second - not by the investors holding the vast majority of the stock. At this level of frequency of prices, a reasonable person must conclude that price changes are unrelated to any analytical derivation based on breaking news. Thus there are other factors driving price changes besides changes in company business or market wide news. The parties to the transaction may have done in-depth analysis of the fundamental factors but this analysis will always involve some specific valuation assumptions that depend on an investor's judgment of the security's risks and liquidity. Essentially, traders try to estimate an unobserved objectively best price for a security. We call this the *intrinsic* value of the stock. Because of the difficulty of correctly performing this task in real time, all traders and investors will make some errors in their estimations of intrinsic value. While we won't go into the details, suffice it to say that those who make bigger errors, lose money to those who are better at estimating securities' correct values.

This pricing mechanism is important because it means there are psychologically driven errors that help or hurt you depending upon when you choose to buy and sell. Over the long run, market participants eliminate pricing errors as more information becomes available. Therefore patience can save you from a loss.

The first point of this analysis is to show that there are two sets of factors determining prices: fundamental "intrinsic" value and the errors in estimating this value that are made by the traders setting prices at any given moment. I think of this second factor as psychological because it relates to the mind and emotions rather than objective factors.

The second point is that the relative importance of these two factors in determining your losses or returns will be linked to the time period you expect to hold a particular investment. In a very important sense, risk is also linked to the time period since the market value of your investment will usually not matter until you must sell it.

In summary, investors often react to emotions - greed and fear. Moods can change rapidly and the result is price changes that cannot be explained by fundamentals such as expected cash flows and interest rates. Over time the market cycles though periods of excessive optimism and pessimism and the returns you earn within a cycle will be strongly influenced by market psychology. Over a long enough period, however, fundamentals determine returns because psychological factors are limited in magnitude and duration. Therefore, if you have a long horizon you need not concern yourself with the volatility of prices that is caused by market mood swings. On the other hand, if you are only investing for a shorter period, these psychological factors may well represent the major part of the risk of your investment.

This view of risk implies that an investment strategy should be tailored to your investment horizon. While a strategy based on fundamentals will provide superior returns in the long run, it may still lose money in the short term and prove inferior to a strategy tailored to the short term psychological "cycle". Of course psychological factors are much harder to predict (at least for me) than fundamentals. Thus, my strategy for short term investing is to stick with investments whose intrinsic value involves fewer assumptions so that they are relatively unaffected by market moods - i.e. fixed income investments tied to short term interest rates.

The above analysis begs the question as to what is meant by long term versus short term. I.e. how long do we need for fundamental factors to outweigh psychological factors. For the record, I have done no formal analysis of this question. My experience tells me that it could take two or possibly three years for fundamentals to outweigh. In "The Little Book that Beats the Market" the author presents statistical evidence that indicates three year horizons are sufficient for a fundamentally based strategy to show superiority[1]. Please keep these points in mind as you read about the results we achieved in 2006.

## 2006 Performance Review

In general, it was a good year for investors. The S&P 500 gained 13.6% in 2006. Berkeley Investment Advisors has two model portfolios meant for clients

[1] More precisely, Joel Greenblatt found that the simple strategy described in his book beat the market averages in 95% of the three-year periods he looked at and that it never lost money over any of the three year periods.

with long term investing horizons. The first is called Long Term Value. This portfolio generally has 25 to 30 positions - it is far less diversified than either the S&P 500 or a typical mutual fund. We concentrate on closely following our best choices for long term returns rather than diluting our focus and giving up some returns to reduce short term volatility. The downside was realized in 2006 as this portfolio lagged 5% behind the S&P 500 index - returning just 8.6%. The underperformance can easily be traced to our big bets on the energy sector and our investment in a start-up drug company. This drug company lost 33% in 2006 on virtually no change in fundamentals after gaining nearly 50% in 2005 - such are the vagaries of market psychology. Our energy holdings were down significantly: some positions lost more than 20%. The single biggest hit to performance came on October 31st when the Canadian government broke their campaign promise by announcing they would drastically boost taxes on our Canadian energy trusts. We had four trusts whose declines ranged from 13-24%; this single event cost us roughly 2.5% of the portfolio in two days. As discussed in my November newsletter, the news was bad but the market reaction worse. I expect very good returns on these positions going forward.

In general the market seems to undervalue the energy companies' future earnings and dividends. Either the market believes that oil prices will drop or it is forecasting some big change in the economics of the business such as higher costs or taxes. While high inventories of oil combined with rough balance of demand and supply of oil brought prices down significantly since July, the longer term forecasts indicate that oil prices will need to rise further to keep demand and supply in balance. Thus we are very comfortable holding oil companies whose stock prices can be as low as just 7 or 8 times trailing earnings.

Our second portfolio for long term investors is called Special Situations. In this portfolio we buy stocks that are extremely undervalued in the market because of some event that has happened or is expected to happen. Because we must wait for events and enter the stock in stages, we typically hold less than 10 stocks and a large part of the portfolio in cash. This leads to very high short term volatility but is expected to beat the market significantly over the long run. Fortunately for our investors the long run came early for this portfolio. In 2006 Special Situations portfolio was up 63.1%. The best performing special situation was a financial company with bad press but good business - it increased more than ***100%*** during the year. At year end the portfolio has a rather high allocation to cash as we wait for the first opportunities of 2007.

So we had a laggard and a leader. Generally we recommend clients only put 20% of funds into our Special Situations portfolio and 80% into the Long Term Value portfolio. For this blend of our results a client would have earned an overall return of 18.2% (.8 * 8.6% + .2 * 63.1% - 1.3% fees and brokerage costs). This is just a bit under my results for my own retirement accounts where I take slightly more risk.

## Conclusion

Although the recommended client portfolio only beat the S&P 500 by 4.6%, I am very satisfied with the result because I do not expect as much out performance in a bull market as I would expect in a bear market where our focus on value stocks really pays off.

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