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# Investment Newsletter – September 2009

The main article this month, on using risk management to achieve superior returns, is adapted from a presentation given for an investor club called $ums In Retirement Investment Group. Before that, I'll give my analysis of the current market environment for real estate, stocks and bonds.

## Real Estate Market Outlook

As explained in the last two newsletters, the prospective returns for real estate investing are very good for residential income property. Valuations are at levels not seen in 15 years (at least). Low interest rates, combined with the likelihood of accelerating inflation, will produce very good returns for those investors who can act quickly to go after bargains and secure financing while rates are still low. It is not that economic conditions are good for rental properties just now; it is that prices reflect current troubles and provide plenty of upside for when things turn around.

## Economic Outlook and Implications for Stock and Bond Markets

Economic statistics indicate that the U.S. economy grew in the 3rd quarter, mostly because businesses completed their adjustment to the new lower rate of consumption in the economy and so they no longer needed to reduce inventories. Government borrowing and spending is also increasing, but consumer demand is still not growing because jobs are still being lost. The government has done all it can to borrow our way to prosperity but like charging your vacation on your credit card, the bill will eventually come due. In short, the recovery that you hear about on the news is not significant to our long run prosperity and is likely to be followed by a second recession in 2010 – i.e. a "double dip" scenario.

A coming wave of mortgage resets and delayed foreclosures will reveal the lack of real capital in the financial system. This has rendered monetary policy impotent to provide stimulus to investment activity. As this plays out, we can expect a great deal of volatility in the markets. Current market valuation metrics are not cheap. The price to earnings ratio (P/E) for trailing 12 month earnings for the S&P 500 is 141 and even forward P/E is 24.8. Over the last 20 years the median trailing P/E is about 22. If we use trailing 10 year earnings to smooth out fluctuations in margins we're currently at a P/E of 19. The median of this measure over the last 100 years is 14.4. We'll look at this a bit more in the article on risk. Market prices for many securities reflect a robust recovery which is not at all likely given the underlying problems that have been swept under the carpet temporarily. On the other hand many parts of the fixed income market will produce good returns with lower risks. Inflation is a potential spoiler for the bond market but this may take some time to materialize and high yield bonds look like a good deal.

So far this year, the average client is up about 15.5%. This is more or less in line with the market but with much less risk: our hedging strategy has worked well. Third quarter earnings, coming out over the next few weeks, may still push the market higher so there is still time to collect some upside while preparing for a reduction in risk taking. Later next month we will shift some assets towards fixed income instruments to dampen the effect of volatility on the portfolio and to boost returns in what is likely to be a stagnant market over the medium term.

**Achieving Superior Results by Understanding and Managing Risk**

Knowing which risks to accept and which risks to avoid will produce better returns along with a sounder night's sleep. In my big picture analysis: The keys for managing risk are knowledge and psychological discipline. We'll start by discussing the main sources of investment risks. Then, we'll look at managing those risks and how that translates into higher potential returns.

Economic and Political Risk is the main source of real fundamental risks. Market supply and demand and the government policies that affect these are the major determinants of economy wide profits and therefore returns on investments. Changes in taxation, monetary policies or regulatory rules all can have significant effects on financial results across the entire market. These are the main risks I am concerned with. Analyzing the implications of events and trends and investing accordingly is the most significant source of excess return compared to buying and holding an index fund. While economic and political factors show up as changes in market prices, the impact of these factors is generally spread out over longer periods of time - as real world events play out.

Market risk is the day to day fluctuations in valuations that have more to do with market mood swings in terms of risk tolerance. I.e. the greed and fear factors that cause price to earnings ratios to change significantly without news to justify such changes. Let's consider an example. Apartment Investment Management Co. is a real estate investment trust (REIT). Its ticker is AIV. REITs are typically valued based on a multiple of funds from operations (FFO). In a normal economy any multiple below 10 should produce a good return for the risk. On March 30th AIV closed at $4.99 per share which was 2.8 times projected 2009 FFO. On May 21st AIV closed at $9.25 up 85% in less than 60 days. Earnings came out and the 2009 forecast was unchanged - so the multiple rose to 5.1. What happened? Nothing happened, except that the company cut their dividend - which was expected. Market participants felt less risk averse and so were willing to accept lower returns for the same risks. Thus they bid up stocks to higher multiples with no change in economic factors. The reverse is also true. Market-sentiment-driven valuation changes are the second major risk factor.

Psychological Risks: for some this may come as a surprise but many studies have found that human psychology is itself a source of risk for investors because their emotions and biases cause them to make poor investment decisions. From 1984 through 1995, the average stock mutual fund posted a yearly return of 12.3% (versus 15.4% for the S&P), yet the average investor in a stock mutual fund earned 6.3%.

That means that over these 12 years, the average mutual fund investor would have accumulated more than twice as much money by simply buying and holding the average mutual fund, and more than three times as much by buying and holding an S&P 500 index fund. {Cumulative returns: individuals = 108%, mutual funds = 302%, S&P = 458%} There is something in most people's nature which compels them to buy high and sell low. This is just one aspect of psychological risks.

"*Investing is not a game where the guy with the 160 IQ beats the guy with the 130 IQ…Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing." – Warren Buffet*

Finally there are company specific risks. Individual companies may outperform or underperform their industry or the market at large based upon their particular portfolio of assets and the skill of management in formulating and executing plans to maximize returns on capital and shareholder value. Company leverage and risk management play an important role here and financial management expertise is very important.

**Managing Risk**

Our task is to manage these risks in such a way that we earn good returns for the lowest risk. Probably the most well known risk management technique is diversification – not putting all your eggs in one basket.

Most importantly, we must diversify across companies. If you buy funds this is automatic as each fund will hold many companies. But here's the tricky part – how many companies should you hold for risk reduction purposes? When you go from 1 holding to 2 you've cut you risks in half. When you go from 2 to 4 you've cut them in half again. As the number of holdings rises, the benefit from adding one more company drops. And there are costs to holding a large number of companies. The more you hold, the less time you, or your money manager, can spend understanding each business and the less likely you are to have market beating returns. If you hold 500 stocks you automatically will get the good with the bad and you'll get average returns. Generally if you're actively managing a portfolio you probably should not hold more than fifty positions; thirty, including some exchange traded funds, is probably where you want to be - assuming you have time to follow the individual companies you hold.

You also need to diversify across economic factors. Buying thirty oil producers will yield low company specific risk but huge oil price risk. You will want to overweight some factors and avoid some factors completely depending on current conditions. But, be careful not to be so confident that everything depends on being right about everything. We can look forward two years and see that energy prices will likely increase dramatically. Thus we want to overweight that sector substantially but this must be tempered by the realization that even if we're right about what will happen it might take much longer to happen than expected. So, it's prudent to look for other themes - so that even if you're wrong about some things you can still perform well by being right about other things.

I'm very excited about future returns for oil and gas producers so I put 25% in this sector and another 6% in offshore drilling companies. We also focus holdings on other industries that will benefit from inflation and a weak dollar such as gold miners, real estate, and companies outside the U.S. This positioning mitigates some of the substantial economic risks faced by U.S. investors and each sector has its own separate risks rather than sharing a common downside (other than the economy as a whole). Gold mining earnings are in fact almost completely unconnected to the economy's performance.

Next we must address how to manage psychological risks. Without a doubt your emotions will be the biggest barrier to successful investing that you will ever face. If you can control them well enough to avoid the 3 most common mistakes you will do far better than almost everyone else.

First – don't buy something just because it's going up. It's OK to invest in something going up but you need to understand at the fundamental level why it's still undervalued when you invest. Buying because it went up is called a momentum following strategy. Sometimes it is successful but it is very very risky. The housing market is a perfect example of why you shouldn't do this. If everyone is buying because it can only go up, there is a very good chance it's about to crash down.

Second – don't sell something just because its price went down. If new information came out and your analysis shows that it no longer offers a good return for the risk, then dump it. But, often a wave of selling knocks down a stock price so much that even if there was real bad news, the new price may be too low. The point is that you need to base decisions on the price relative to your estimate of underlying value rather than selling in a panic along with the herd. The lemming like behavior of most investors is what provides us an opportunity to do better - but only by resisting our emotions.

Third – don't leave money tied up in a particular stock because its price went down. This may sound contradictory to the second key but it's not. If you bought something and then new information reveals that its value is lower than its current price – sell it even if it means taking a loss. Your emotions will tell you to hang in there until it recovers. Unless you can't find any better investments, ignore your emotions; take the loss and move on to better investments. You don't have to make back the money in the same stock to make it back.

This brings me to one last tip for reducing psychological biases that can cost you money. Look forward, not back. Look forward to estimate returns and risk when evaluating not only new investments but those you already own. The past is often a very poor indicator as to future returns and risks. In fact many times it is completely irrelevant. Do you have some stocks you're holding because you need them to rise enough so you won't realize a loss when you sell? Have you done the analysis that convinces you that these stocks have the best potential returns available for the risks? The price that securities have traded at in the past is irrelevant to projecting future returns. Only the current price and expected future price matter. Let go of your fear of regret and move on to better investments based on information and analysis. The bottom line is - if you don't have the temperament to keep you emotions out of your investment decisions, hire a good advisor (like us) and trust them.

Now let's look at timing of market entry and exit. The mood of the market swings wildly and valuations along with it. Underlying these day to day gyrations are longer term trends driven by economics and fundamental business results. When you tune out your emotional reactions you can focus your intellect on rational analysis of buying and selling opportunities.

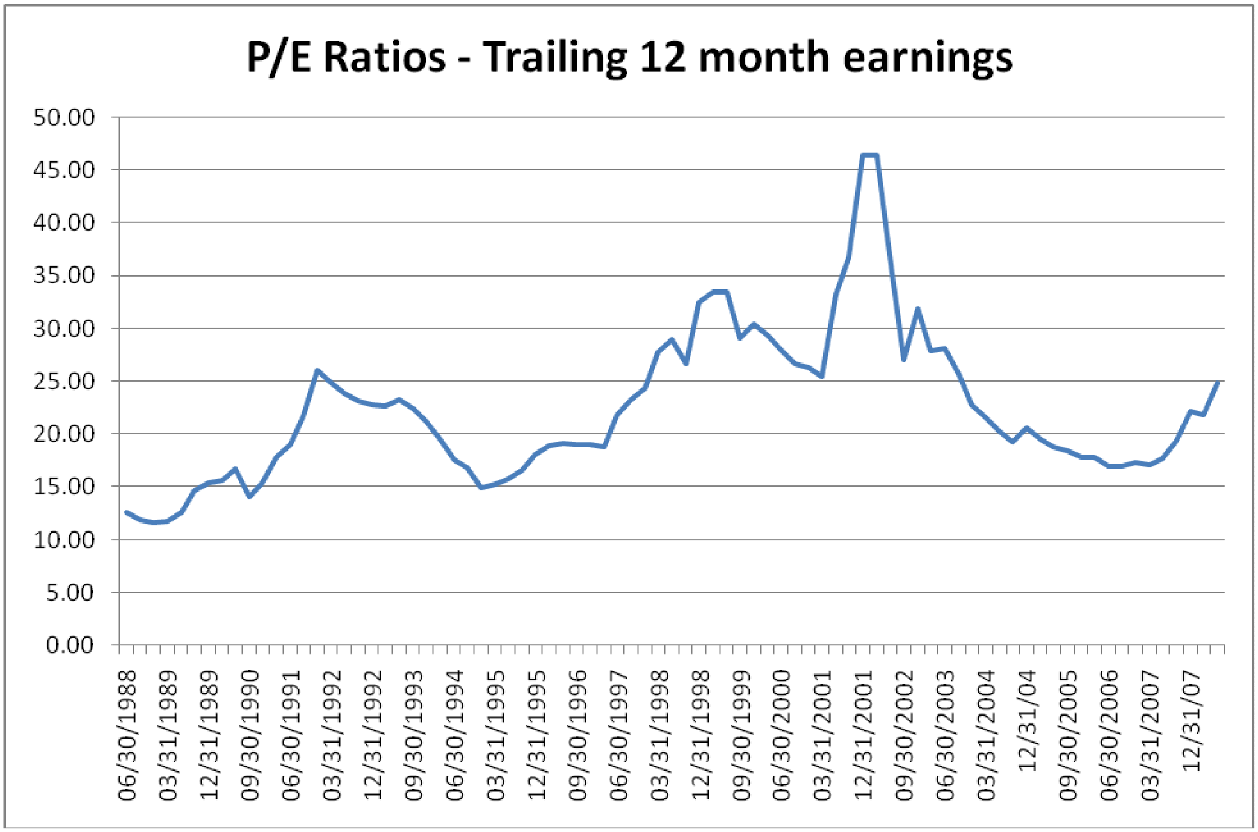
You must read and understand economic news to have any hope of avoiding events like the market meltdown we saw in 2008. Read the Wall Street Journal every day if you manage your money. Here's what I wrote to my clients on Jan 10, 2008:

*"Last week the preponderance of evidence reached the point where I believe the U.S. is now in a recession. Even though I believe our positions in Long Term Value and Special Situations will outperform the market over the long term, I think it is prudent to reduce the risk of portfolio. I am doing this by reallocating money out of the long term value portfolio into a new hedging portfolio and into less risky fixed income oriented portfolios."*

Several months of data led to my decision – the final straw being the employment number for December. Ten months later came the official announcement that a recession had begun in Dec. 2007. This analysis and caution saved us a lot of money and probably saved many clients from selling at a bottom. If you pay attention to the data in the context of similar indications from the past you can see what's coming. But you'll need to ignore most of the market spin on the news which distorts bad news into good news and vice versa. When you draw a conclusion that either the risks or expected returns have fundamentally changed, you need to react by increasing or reducing your risk level accordingly. You especially want to pay attention to signs of trouble because it's easier to deal with losing some upside than losing some principal. If you lose 50% you need a 100% return to make up for it.

Besides understanding the economic environment, evaluating stock valuations is very important for making individual security buy and sell decisions. I.e. we must evaluate the current market price of a given stream of expected earnings as reflected in the price to earnings ratio. While expected earnings may change very slowly, the market's value of these earnings changes minute to minute.

If we over-pay for the projected earnings of a stock we can think of this as accepting a risk premium that is in some sense too low for the risks taken on. Overpriced stocks, on average, lead to losses or returns below expected return for the fundamental risks you accept. But stocks are complicated; let's think about a simpler example to illustrate the point. Real estate provides a useful analogy here. I like to use Real Estate because people think about it differently – meaning that most people take a long term perspective. Despite recent evidence to the contrary, most Americans will tell you that their home will go up in the long run and therefore it's less risky. But as reality shows, if you paid 30% over the true long run market value because you bought in an overheated market or just had to have a certain house, your gains over your holding period will be much less than if you got lucky and paid 30% under the long run equilibrium market value. With regard to real estate, there is a loose but definite connection between values and the income of people who want to live there. This connection was historically enforced by lenders only lending as much money on a house as the borrower could reasonably pay back. This discipline, combined with the level of interest rates, set the Price to Earnings ratio of houses. If you buy when underwriting is lax and interest rates are low, you can pay a very high P/E ratio. But over time these will revert to the norm and falling P/E ratios imply falling house prices. The same thing happens with stocks. The negative returns we've seen over the last 10 years for the S&P 500 is a direct consequence of inflated P/E multiples from 1999.




{Source: Standard and Poors – based on reported earnings}

In June 1999, the S&P was trading at 33 times trailing twelve month earnings. The median P/E since 1936 has been 15.5 so stocks were more than double their historical median. This is a risk that definitely can be eliminated through careful analysis. In fact, as in the real estate analogy, pricing errors can go the other way and reduce the risk of not getting your required return. If a bank forecloses on the house next door and you get to buy it for 60% of market value, you have a pretty low risk of losing money on the investment.

Underpriced stocks lead to gains or returns above required returns – or at least a cushion against your estimation errors. In 1999 I was buying REITs at historically low valuations – 10 or less times Funds from Operations which led to good returns while the rest of the market tanked.

Let's explore this connection between valuations and risk and return a bit more. The two things that determine stock returns are the company's returns on capital – the cash flows it generates on its investments, and how those cash flows are valued by the market.

The basic idea is that if we pay a relatively low price relative to asset values or cash flows then we are not so dependent on the whims of the market for our returns. We won't need great things happening for the business in terms of earnings growth in order to get a reasonable return because the company can provide good returns using its current earnings and assets. In normal markets there is a lower limit on the value of cash flows because management will act to use company cash flow to buy stock when the price gets so low that their best investment is the stock itself. The same thing can happen with debt which is why we're seeing so many companies buying back miss-priced debt securities. On the other hand a company like Amazon that trades at 60 times earnings can fall by 75% and it still wouldn't make sense for management to buy back the stock. Let's look at some statistics

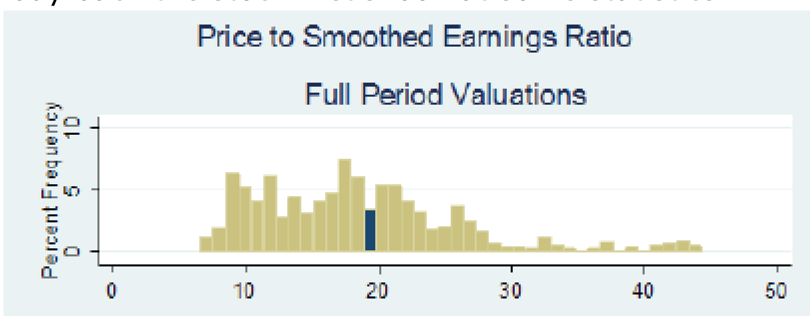
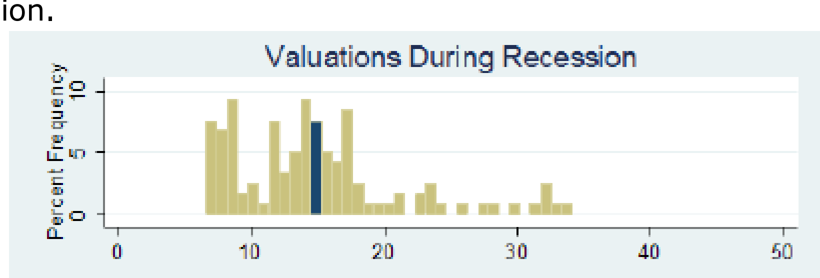



Chart 1 is a histogram of month end S&P 500 P/E ratios since 1950 using the average of 10 year trailing earnings as per Gary Shiller's calculations. The dark bar is the average. The lower histogram, Chart 2, shows only the months when the U.S. was in a recession.




This is useful because it can give you some sense of the range of results that are possible for a given underlying earnings stream. What this tells you is that if you are buying in 1999 at a multiple of 33 then the probability of a persistently lower P/E's 10 years out is more than 95% so you will need very high growth in income – which is also very improbable. On the other hand if you're buying into the market when the P/E ratio is 10 or less the chance of seeing a persistently lower P/E is less than 10%. Hence, since overall GDP growth and long run earnings growth are fairly constant, your risk of negative returns is inversely related to the level of P/E at which you buy into the market.

I've illustrated this at the market level but of course this also applies at the company level. The underlying mathematical concept is the discount factor by which we turn future expected cash flows into values today. The more uncertain these cash flows are, the higher this rate should be. Most importantly we should pick those investments whose returns meet our goals while exhibiting the lowest risk of cash flows falling below expectations.

What I'm suggesting is that you must be constantly assessing risk and return offered by the market by evaluating both the economic environment and valuations and tuning your level of risk accordingly. When risks are high because the economy is faltering, dial back your risk exposure. Even when times are good, if valuations are very high relative to long run expectations, avoid overly expensive stocks. I don't mean dollar price here, I mean stocks with low risk premiums relative to the norm. Conversely, if valuations fall to levels that offer above your required return for the economic risks, increase your exposure by buying the securities that offer good returns. Notice that this means buying low and selling high, the opposite of what your emotions will tell you to do.

**Putting it All Together**

How do we do this? First, you need to understand the historical context of what levels of return are required by the overall market. At the portfolio level, a general selloff will affect you no matter how good your picks are. So if you see a recession coming before anyone else, you should reduce risk by moving to safer fixed income investments or by going short the market indexes while still holding your good picks. Then, even if the market declines, you can make money so long as your picks outperform the market. Conversely, as the market gets cheaper relative to future earnings and growth prospects, gradually reduce hedging and rebalance away from fixed income towards undervalued equities.

For individual positions, evaluate what the risks are for achieving earnings growth expected by you and the market. Look out to the future – say 5 years and figure out the range of potential values for the stock. Pick a point in the range that you are comfortable with accepting the valuation risk on. For example, suppose we're considering a REIT. In a normal market they will trade at somewhere between 8 and 12 times funds from operations. Given the very high uncertainty in the current environment we may well only feel comfortable that they will get to 8 times FFO in 5 years. The other risk here is bankruptcy. Since refinancing debt is difficult in the current environment, there is some risk that any particular REIT could go bankrupt. We need to look at their business and financial structure and assess whether we are comfortable with this risk.

So, let's say I'm looking at the REIT I mentioned earlier, Apartment Investment Management (AIV). Suppose I estimate there is a 5% chance they will go bankrupt and I'll lose my entire investment – otherwise their cash flow will recover and they'll grow it by at least 25% over 5 years. Using a conservative 8 times FFO if they survive, I calculate that this will be worth $18 per share in 5 years if they survive and along the way I will get dividends of $1 per share each year after this year. At the closing price of $9.25 from May 21st, my return from this would be 20% annually for 5 years, and I would end up earning about 2.4 times my investment. For me, this is an attractive risk versus return proposition so long as I diversify across such opportunities to reduce the hit I would take if they did go bankrupt.

This stock went up 85% from March 30th to May 21st. Once the price rises another 50% (as it has now), the expected return drops to 10% and a multiple of only 1.6 over 5 years. Even though the stock would still be below its normal market valuation range, the return would be too low for the heightened bankruptcy risk of the current market environment and there would be other opportunities with higher returns for lesser risks. Thus we sell it – despite our happy history with it.

The lesson here is that we must be disciplined about price targets both for buying and selling. Let cool headed analysis drive your decisions and don't fall in love with your stocks. When they get so expensive that you wouldn't buy them, it's time to sell.

**Invest with Knowledge: Learn it or hire it**

In practical terms, to be able to properly assess the market's current offerings of risk and return, you must invest with knowledge. Invest in what you know. If you don't understand the risks and likely returns you shouldn't make the investment unless you are being advised by a professional who does have the specialized knowledge to assess the risks and returns. Tips from friends are either illegal (if based on insider knowledge) or probably worthless – if not based on special knowledge.

If you are making your own decisions, focus on educating yourself in the areas you are most interested in investing. Specialize and analyze. If you don't know much about an industry, hire an adviser who does. If you pick someone knowledgeable, the avoided risk and extra return should more than compensate for fees. If you don't want to work with someone, and don't have time to analyze a particular industry you want to invest in, then stick to diversified ETFs. You'll give up some returns compared to picking the best companies, but if you have no basis to analyze risk and return, you should diversify to manage risk.

Finally, hire an Advisor to analyze your situation in a structured way and consider giving them a part of your portfolio to manage. The old saying that two heads are better than one is worth heeding when it comes to your investment portfolio. In my experience, almost everyone can benefit from having an advisor analyze your situation in a very structured way to help you develop a comprehensive strategy that rationally lays out a course for achieving your goals within the limitations of your resources and your tolerance for risk. Get a good plan from a smart advisor and give them a chunk of your portfolio to manage even if you keep most of it. This gives you two brains working on the problem and gives you a source of independent advice to bounce ideas off of. It will almost surely reduce your risks and increase your returns.

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