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Commentary

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Short Term Evaluations in a Long Term Strategy

When I first started in the business, about a million years ago, the highly respected Templeton Funds which was independent at that time, would send 1 statement to investors per year - just one.

Years ago, I was lucky enough to go to a Templeton Due Diligence meeting. The question of the single annual statement was posed to Sir John Templeton. His response was simple. He explained that investors have no need to look at their statement any more often than once a year. Looking at it any more often might only confuse them. He explained that if they have given Templeton their money to manage, (by investing in a Templeton mutual fund) that showed they trusted Templeton and should have no need to look at their money any more often than once a year.

Oh, how times have changed!

Today, investors can get up-to-the-second portfolio valuations sent to their iPhones. They can trade securities from their favorite electronic device and can make split second decisions based on the latest news release.

Short term does not always equal Long Term
However, Templeton's philosophy still rings true. Short term evaluations can do a lot of harm to long term strategies. With all of the "up to the minute" information available to investor's today, there is considerable pressure put on money manager's to perform not only in the short term, but in the micro short term. This is very bad for strategic long term performance.

Short term thinking lacks two of the most important characteristics that make a successful money manager – Wisdom from experience and a vision of the future. Short term assessments are usually based on short term, past performance. What is missing from short term thinking is how an investment fits into the overall plan of a portfolio or how the portfolio is positioned to benefit from future events and trends as opposed to the current market environment and past performance.

How short is short term? It can be as short as a month or as long as a year or so. Within any long term trend, there are going to be reversals, corrections and countertrends. It is inevitable. Anyone that wants to either A: Sell before any counter trends, or B: Never see their portfolio decline, should not be investing. This is because it is impossible to get out of the way of all countertrends. Reversals and corrections can happen with no warning. When any market has a down day, it could be the beginning of a several month decline or just a single day decline. Short term movements can be very unpredictable.

(My apologies to technical analysis, which focuses on short term movements of charts, not economic or company fundamentals. This report is about fundamental analysis, not technical. We utilize technical analysis for trading purposes.)

Long Term Trends
On the other hand, long term trends can be identified and predicted. They can be analyzed and understood and the long term impacts can be identified. For instance, with the urbanization of populations around the world and the

Poor Short Term, Great Long Term Performance

In 2006, gold had a fast 25% correction over a couple of months. An investor that judged an investment in gold by the performance over those few months would have missed the bigger picture.

Gold recovered to go on to all time highs. Today, it stands near its all time high and the poor performance of the US Dollar and the potential for inflation heating up means gold could be ready to head much higher. Fundamentally, gold is in a bull market, but that doesn't mean it can't have a correction. We would expect to see a correction of at least 20% at some point. We would view this as a buying opportunity, as long as fundamentals remain strong.

growth of those populations, water resources will need to be dramatically increased to meet the demands of the additional users. The impact could be on water purification companies, municipalities that have to supply water, factories that are polluting rivers and consumers that need the water.

What isn't known is the exact timing of various parts of the trend. We know the trend of the population is rising. We know the need for clean water is rising. What we don't know is the exact timing of when a tipping point will be hit that will push a country to invest heavily into water desalinization plants or pollution clean up programs. Being in the game ahead of time assures an investor they will be there as the trend develops and gets stronger. Proactive research looks for evidence of trend development. By the time many investors are aware of a trend, it is usually already established.

The situation with the US Dollar is a trend that is becoming more apparent every day. We know foreign countries, including China, Russia and India, have called for a new reserve currency. China is already doing business with many foreign trading partners in Yuan instead of Dollars. We know that the IMF and UN have called for a new reserve currency to replace the US Dollar. We know what the Fed has done to its own balance sheet and how this is devaluing the Dollar. We know what the White House is predicting for future Federal Budget Deficits and how this may hurt the Dollar. So it would seem, the trend is set, the Dollar's further decline should be no surprise, as it has already declined 36% since 2002.

Yet, some expect the Dollar to rally. We also expect it to rally. The impact this could have on investments is wide. Gold and other commodities like oil would likely decline. International equities and bonds, and domestic stocks could also drop.

But would a rally in the Dollar be a reversal of its downtrend or just a temporary, bear market rally? The fundamentals give the answer. Has the Fed reduced its balance sheet? Has the Fed brought back in much of the liquidity it dumped into the system last year? Have the Federal Budget Deficits been reduced? Are foreign countries easing off on the pressure for a new Global Reserve Currency?

If nothing had changed, then the downtrend for the Dollar is still on and the rally will be nothing more than a Bear Market rally, or short covering. The rally, and corresponding declines in other markets could be short term opportunities. Gold, oil and emerging markets might come down significantly. This could present a buying opportunity.

Know the Differences

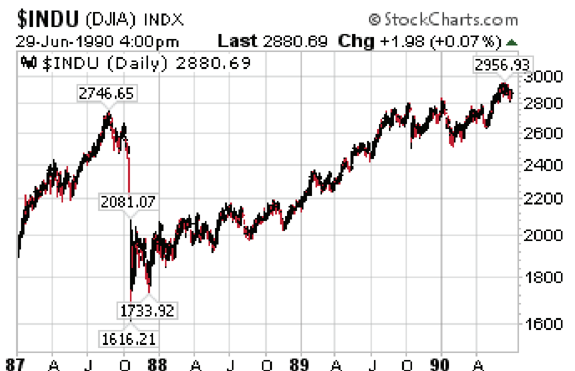
Not all declines are buying opportunities. Two of "Riley's Rules" for prudent investing are these: 1) Sell Bear Market Rallies; Buy Bull Market corrections. 2) Hold investments that are in a long term uptrend during a correction, and hold onto shorts during bear market rallies. The key is being able to identify the difference between a bear market rally and a bull market; and a correction from a bear market.

Short term evaluations will not help you do this. Investors need to have a long term view to really understand where we've been and where we are going. Comparing this month's statement to last month won't do. Comparing this month's to last year may not even be good enough. You could be in the right investments, but the market just hasn't cooperated.

The period from 1998 to 2000 was just such a period. Never had the market traded at such high overvaluation levels for such a long time. Anyone that got out of the market and put their money into

How a bad short term buy can turn out to be fine in the long run

The Crash in 1987 produced a 41% loss from the summertime high to the crash low. Had someone bought the Dow Jones in the summer of 1987, they would be quite unhappy with their short term performance.



Thanks to sound economic fundamentals, the market recovered within two years and the bull market that had started in 1982 continued. This illustrates two of Riley's Rules - Buy bull market corrections & hold onto assets during bull market corrections.

And as we all know by now, the bull market continued up, with a few more bumps along the way until it ended in 2000. The Crash in 1987 is a small bump in the long term chart of the bull run from 1982 to 2000.

CIS

the safety of T-Bills in January of 1999 looked pretty foolish for the following 15 months, as the stock market went straight up to record highs.

Then the market turned. In March of 2000, the bear market began. It is our belief that it still isn't over. But an investor that stayed with a strategy of buy and hold in an S&P 500 type fund would have performed pretty poorly compared to the T-Bill investor. Short term - the first 15 months - the T-Bill investor was looking pretty bad. But long term, the T-Bill investor beat the S&P 500 easily. (See chart)

Why? The long term fundamentals were against the stock market. Not just in March of 2000, but for many, many months before the market peaked. The smart money got out early and didn't look back.

Bond Have Trends too

Bond investors are especially vulnerable to getting nervous about short term performance. Interest rates are the single most important variable in determining the market value of bonds. Short term swings in rates can cause bond prices to move wildly. But secular changes in interest rate trends are rare and need to be addressed. If rates are expected to rise for the long term, it is wise to shorten maturities and increase quality.

Using Fed data (See charts next page), the last bond bear market lasted over 30 years. Interest rates rose until they peaked in 1981 when 10yr Treasury rates hit the mid teens. Today, rates on the 10yr Treasury are the same as they were in the early 1950's, when the last bond bear started. Anyone that tried to hold onto their bonds while rates rose from about 4.25% in 1965 to almost 8% in 1969 may have also seen their bond portfolio decline as much as 50%, depending on the kind of bond and maturity.

But rates didn't go straight up. There were some declines that allowed investors the opportunity to get out of their bonds and shorten maturities. But, for instance, if in January of 1976 an investor sold off some of their bonds, they may have watched the bond market rise the rest of the year as rates continued to decline. Had they held on, they could have sold their bonds for better prices. So short term, they made a mistake.

But the fundamentals were against the bond market back then and within 12 months of the 1976 low in rates, they shot back up and the bond market fell. In fact, from the 1976 low in rates to the 1981 peak, rates more than doubled. This would have been a disaster for long term bond holders. Shortening maturities was the right thing to do, even if in the short term, it may not have looked that way.

Discipline and Patience …and Trust

There are cures for "short term-itus", (the focus on short term performance over long term strategy). Two cures are discipline and patience. Investors have heard this over and over again for decades and it is still true today - Investors need to be disciplined. They can't allow themselves to let their emotions take over. Greed and fear are the worst enemies of a sound long term strategy. Greed and fear is the abandonment of discipline. Investing is not a game, it is not a sporting event and it is not a gambling casino. Those are the proper domains for letting your emotions run wild. While you can act with abandon at a Patriots game, get excited at a blackjack table, investors need to keep their emotions in check when investing. Rational, cool-headed investors win. Emotional investors chase yesterday's winners and lament when a long term strategy isn't working just right.

Why You Sell Bear Market Rallies

Bear market rallies can be enticing. People want the markets to do well. So after a decline, investors have a willingness to buy into the hope of a recovery.
But, even though it didn't look like it at first, any sell during this bear market rally of the Nikkei in 1990 would have been considered a good sell, even though the market rallied about 18%. Why?

After the bear market rally ended, it was followed by a continuation of the bear and the market lost an additional 40% in less than a year. Two years later, it was cut in half. Poor fundamentals drove the market lower.

The chart above is the Fed's worst fear, a 20 year deflationary bear market. So far, the Japanese have lost 75% of market value. Don't believe the hype that some will tell you that bear markets don't last very long.

Patience is the other key to curing "short term-itus." If the research is done right and the assets are allocated properly, then investors can sit back and relax. Farmers don't run out to the fields the day after they planted their crops demanding to see vegetables. Ranchers don't expect to see calves the day after they take the bull out of the cow pasture. They don't fret or second guess that the corn crop isn't growing fast enough or that the mama cows' pregnancies are taking too long. They have patience. They planted good seed, so now they wait. Mama cow isn't going to drop a calf any faster just because rancher John is pacing in front of the barn.

Having patience isn't easy in the fast paced, immediate gratification culture we are in. This is why patience and discipline are what separates the successful long term investors from those not so successful.

In my nearly 25 years in the business, experience has taught me two things – 1) There are almost no successful long term traders. They almost always hit a bad patch and that is it for them. They usually get burned badly, many losing almost everything they have. 2) Most old-timers in the money management and brokerage business are long term investors, not traders. They have seen it all, they have watched the young guys come into the business full of vinegar, going to show the old-timers how it's done and they burn out, just like most traders.

The last cure for "Short Term-itus" is trust. In an era of too much information, the value of sound research and fundamentals analysis is lost. Investors are bombarded with so much data and contradictory opinions that it becomes just noise. It becomes almost impossible for them to be able to distinguish between good research and bad. (Yes, there is bad research and wrong opinions. Everybody may have an opinion, but not everybody is right.) Since too much research can become just noise, investors can easily fall into the trap of looking at short term performance as their measuring stick for credibility.

It amazes us how many investors are still clinging to the words of research analysts today that completely missed the problems in 2008. They never saw them coming, yet investors are more than willing to continue following these pundits. Investors sometimes trust the wrong things, the institution that a person belongs to or the reputation of a company. Fed Chairman Bernanke being interviewed on financial news shows is proof that repeatedly being wrong doesn't keep them from coming back for more.

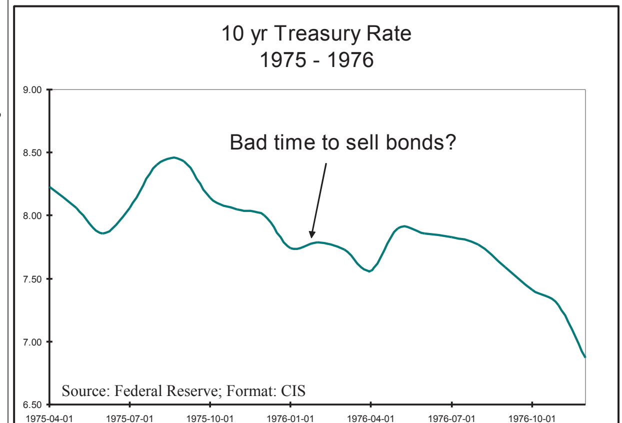
Investors need to trust advisors that have proven themselves and whose research is based on fundamentals that the investors can grasp and recognize. At its most basic, economics is simple. Supply and demand rule economics. Everything else is just piled on top of that complicating it. Throw in human nature and you can see why it gets confusing.

Another Football Analogy

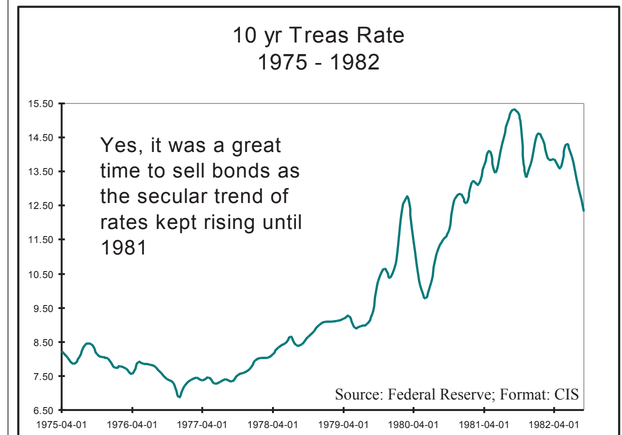
Jimmy Johnson, the Dallas Cowboy's head coach from 1989 to 1993 is a good example of trusting a strategy. His first year as head coach, the Cowboys won only 1 game. But the team owner stuck with his coach and his strategy. By 1992 they had won the first of two Superbowls.

To be a successful investor, you don't need to win a Superbowl. But you do need a strategy and a plan for consistent long term performance. And in many cases, you need a trusted manager to execute the plan. Most investors don't have the time, experience or discipline.

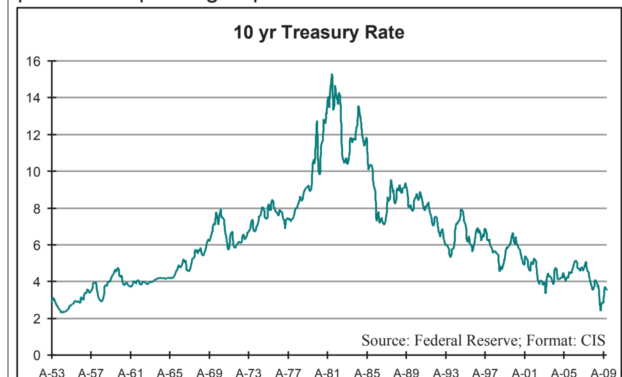
Bonds Have Trends too



Bonds rallied from 1975 through 1976. Someone selling a bond midway through the rally might have looked foolish for a while.



But then the bond market headed lower again and rates headed higher. As rates went up to the mid teens by 1981, investors that held onto their bonds could have lost as much as 50% of their portfolio's value, depending on ratings and duration. For those of you thinking to themselves, I would just hold until maturity and not lose a penny. That is true, you could do that. But it is my experience investors don't like receiving 7% on their bonds when new bonds are yielding 14% and investors don't like to see their portfolios down 30, 40, or 50 percent for prolonged periods of time.



Here's the last bull market and bear market in rates. Today, rates are as low as they were at the beginning of the last bear market. This would indicate that the next major move for bonds would be down.

Know who you are trusting

Many investors trust their financial advisors out of convenience. They don't understand finances, the economy or the market. They don't want to. They want somebody else to do it for them. They trust the big company the broker works for. This is like trusting the dealer at a blackjack table. Sure he smiles at you and pays you when you win, but he works for the house, never forget that.

If an investor wants to avoid the trap of focusing on short term performance instead of a long term strategy, they need to get to know their manager, understand their investment philosophy and trust their approach. Investors need to use their common sense. They don't need to understand economics to the degree their portfolio manager does, but they need to scrutinize what the manager says and does.

A good money manager will communicate often with clients, at least monthly. This can be done through a written commentary. But again, the investor has to be on his toes. An independent money manager will likely not be obliged to anyone other than the client. But a broker associated with the large investment firms is less likely to be independent and more likely to be offering company sponsored materials and company mandated policies.

Doesn't everybody have a plan?

Hope and luck is not a plan. Jimmy Johnson had a plan that the owner of the Dallas Cowboys trusted, and it worked. All coaches have plans, but not all coaches win the Superbowl. This is because of several factors, the plan could be bad, they could have the wrong players, and the ownership can get in the way.

It is the same for investing. Not all plans are good plans. Some are based on flawed data. Some are based on past performance. Investors should look for plans that look into the future and base investments and strategies accordingly. As they say, past performance really doesn't guarantee future performance. Anybody that based their investment strategy for the past nine years (2000 – 2009) on what happened the previous ten years (1990 – 2000) should have learned this lesson.

You could also use the wrong investments. Just because a stock or mutual fund had a great performance the past 5 years doesn't guarantee that they will have a great performance the next 5 years. But too often investors base their investment decisions on past performance.

Ownership can be a problem in football and it can also trouble in investing. When an investor hires a portfolio manager, they need to back away and let the manager do what he was hired to do. That doesn't mean they should ignore what is going on or accept poor performance. Assuming that the investor has done his own homework and knows the manager and understands the investment strategy, and is getting regular communications from the manager, they should be comfortable enough to back away from the day to day control and monitoring.

This is Templeton's point. If the investor has placed their trust in a qualified money manager, they have no need to look at their portfolio any more than once a year. It frees the investor from focusing on the short term and concentrate more on the long term strategy. Basing investment decisions on short term performance or short term data can derail a sound long term plan. At Cornerstone, we anticipate volatility will increase and investors will be tested. Staying focused on the long term will help investors stay the course.

Hold During Bull Market Corrections

Oil had a 55% correction from September 2000 through November 2001. Watching it drop over 50% was not fun for investors. But the fundamentals were strong and improving for oil.

Oil recovered and its bull market continued for several more years. Fundamentals are still strong, so our expectation is that oil should continue higher for some time.

With oil recently hitting $80/bbl, it has attained our goal for 2009. We anticipate a correction at some point, possibly as much as 33%. Since we believe oil is headed much higher in the long run, we will view any corrections as buying opportunities. We also believe that various circumstances could cause oil to jump $10 - $20 quickly. We feel there is a greater risk to be out of oil than to be in it, which is why we would rather ride through the ups and downs than try to time the corrections and risk being out if a sudden price jump happens.

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