SENSATIONALISM AND THE SMALL INVESTOR

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Last week, I received two copies of the same magazine article in the mail. They were clipped from a financial publication by two different customers and sent to me. This is pretty normal. It is unusual for a week to go by without receiving some kind of emotional epistle offered by my clientele. Virtually, all of these press clippings appeal to the emotion of fear. Those that avoid fear always appeal to the investor's greed. That in itself is not unusual. Markets are driven by two emotions…fear and greed. Perhaps my solicitors are afraid that I don't share the fear that they do and spend twenty-five cents to guard against any disastrous result that may be born of this condition. On the other hand, they may possess a degree of fear that is only partially offset by one's normal greed…this results in confusion…once again the post office gains. Investors who respond to their own greed usually send nothing. Most won't admit to having greed and those who do are confident that the same emotion runs rampant across the planet.

Fear and greed are the active ingredients in the recipe for financial sensationalism. Sensationalism is defined as "the use of strongly emotional subject matter, or wildly dramatic style, language, or artistic expression, that is intended to shock, startle, thrill, excite, etc." What the heck, all of us are human. Without all these emotions, none of us would learn to respect fire, cliffs, gorillas, count our change at the grocery store, etc. I am vulnerable to the emotions of fear and greed just like anyone else. Unfortunately, I have made financial errors as a result. Compounding this problem is the fact that I bear the weight of my customers' fear and greed as well. I have been at the focal point of this phenomenon for the last 18 years. With any kind of luck, I'll make it another 18. As time goes on, I have been able to improve my ability to contain my own emotions. I am 100% sure that my financial performance has improved as a result. Along the way, I try to help my clients develop the same disciplines. The purpose of this epistle is to enlighten the small investor to the sensationalism that runs rampant around him and to conquer the emotions that contribute to this phenomenon.

Like gold and silver, sensationalism is a very valuable commodity. It sells magazines, newsletters, advisory services, keeps viewers "tuned in", and generates commissions. All publications claim to be the friend of the little guy; few of them behave that way. More often than not, magazines and TV shows ride the crest of the current trends, extrapolating data from one month, day, or year, well into the next decade. I am an investor myself and I practice what I preach. It is not unusual for me to show my clients my own account. Do you often wonder how many stocks and bonds the guys on TV own? Could it be that these guys are better actors and writers than investors? Why don't either Warren Buffet or Mario Gabelli have weekly TV shows? It is my experience that the successful investor is typified by the type of individual who can remain calm under fire, hold quality investments for a full "term", and recognize the concept of value.

Why is the investment of money such an emotional undertaking? I have heard the financial markets compared to politics and professional athletics as emotion driven industries; that's not a bad comparison. The financial markets are emotional by design; fear and greed drive them. As most people read this paragraph, they separate themselves from other market participants. No one thinks I am talking about him or her. Retirees regard Ivan Boesky as greedy and speculators envision the true hedger as being fearful. None of us will ever function well in the market place until we come to grips with our own emotions of fear and greed. All of us have them, all of us are victimized by them and none of us will ever totally conquer them. We can, however, use these emotions as road signs that might help us avoid the pitfalls of sensationalism.

The chief deterrents of fear and greed are intelligence, consistency, quality and patience. None of these are well employed without a leg up from your financial advisors. As we discuss all of these elements, be critical of those people upon whom you depend on for financial advice. A good advisor will possess these qualities and have the gumption to confront you when your decisions are not well conceived. None of these qualities are any more important than the next. If an investment decision is expected to last full term, all of these characteristics need to be present at the outset.

INTELLIGENCE…

Most investors are more intelligent than they give themselves credit for. A high IQ is not required, common sense certainly is. To fulfill my definition of intelligence, an investor need only be smart enough to avoid doing things that are categorically "stupid." Learn enough about the nature of the securities you own so that you can understand why you own them. Understand the difference between stocks and bonds. Why do you own one for growth and one for income? If interest rates go up, why does the price of your bond go down? These are simple fundamentals and everyone has the capacity to understand them. We all know that knowledge is power. If you are going to make the financial markets perform for you, this "power" is necessary. Here is a short course in some of the fundamentals.

A bond is purchased for income and may be of high quality, such as treasury securities. Some are of speculative quality, such as junk bonds. Junkers pay a higher rate of return than treasuries but their ability to consistently pay principal and interest is far more questionable. Stocks are purchased for their growth potential; they also vary in quality. Seasoned stocks with proven earning records are considered "blue chip"; more speculative stocks are often referred to as "secondary stocks."

Bonds should be the cornerstone of every serious investor's portfolio. An investment grade bond (also called a fixed income security) will earn the investor a current rate of return, which is normally paid semiannually. When the bond reaches its maturity date, par value (face value) is paid to the investor. The owner of a bond assumes two kinds of risk: interest rate risk and credit risk. Interest rate risk, is determined by the level of competitive rates; as rates go up, the value of bonds goes down and vice versa. Interest rate risk increases with the length of maturity. An investor selling bonds prior to maturity assumes these risks. Credit risk is determined by the quality of the issuer. A young company with an unproven business plan will not be awarded a rating as high as seasoned issuers. Treasury bonds are considered to be the ultimate in quality. All other fixed income securities are priced at some "yield advantage" to treasuries. Junk bonds are of relative low quality and provide investors the widest advantage to treasuries.

Stocks of any quality (also called equities) are highly sensitive to a third type of risk, the business cycle. Regardless of interest rates or the quality of the company, an equity investment is vulnerable to general economic conditions. Both stocks and bonds are subject to market risk. Regardless of the intrinsic value of a security, the market place may not be willing to reward the investor on a given day. Should the investor feel the emotional or financial need to sell securities, he or she will have to deal with the price available in the market place.

So, does a lesson like this make you an intelligent investor? Probably not. What it does do is lay the groundwork for avoiding stupid mistakes. After a small amount of effort, you should know enough to make some basic asset allocation decisions. This will determine the percentage of your assets that are invested in bonds, stocks and money market funds. More importantly, you should be able to assess your own risk tolerance level. How many stocks can I own without being vulnerable to the sensationalism of the media, market gyrations and the malarkey I hear at cocktail parties? How long a maturity can my bonds carry without interest rate risks driving me nuts? The unintelligent investor probably doesn't know these questions exist. An intelligent investor can recognize the questions, at least pencil in the answers, and with the help of a financial advisor build a portfolio that will not overexpose him to the sensationalist editorials of the media.

As we discussed earlier, markets are driven by fear and greed. Regardless of how disciplined we are, all of us are vulnerable to these emotions. Two recent periods paint excellent examples from which to learn. The bull market of the 80's began in 1982 and stubbed its toe in rather grand style in October of 1987. Even my most resolute bond customers began to submit to the lure of the stock market by the end of 1986. Some bought individual stocks and some chose mutual funds, all made money short term and then saw their assets decline on October 19th. Most of these investors were quick to do a 180, divorce the stock market, and reaffirm their pledge to allegiance of bonds. Very few recognized what happened. They did in fact possess the emotion of greed. Greed did in fact overcome their fear of equities. Sensationalism in the press and at social gatherings did in fact influence their judgement.

Consider the equity hound that owned a portfolio full of stocks from the mid 70's thru the early 80's. High inflation, the energy crisis and double digit interest rates dealt stockholders one headache after another. Any bond holding purchased at this time would have offered a yield between ten and fifteen percent. All of us have a financial pain tolerance, that tolerance rises when the investor is making "some" money…any money! Those difficult to justify stock positions are a lot easier to hump when the bond portfolio is spitting out a reward semi-annually. One by one, as the late 70's became the early 80's, the best of the "purist" stock jockeys faded into the crowd. So…how did the big winners maintain their stock positions when the market took off in 1982? Five will get you ten that the most successful of equity investors were able to stay in the game by owning bonds, not all bonds, but *some* bonds.

How do we avoid these soap operas? You probably can't. These sensationalist thunderclouds are going to rain on us no matter what we do. However, you can create the type of asset allocation that complements your risk tolerance. Understand that you are human and vulnerable to greed and fear. I truly believe that it is just as important for conservative investors to own equities as it is for aggressive investors to own fixed income.

Diversification is intelligent. It is an important and key weapon for the investor to employ when fighting emotions in the marketplace. If you favor bonds, own enough stocks to make it through a three-hour cocktail party. If your passion is stocks, own enough bonds to make an occasional alimony payment. Investors who overweight equity or bond positions subject themselves to an over-exposure of sensationalism. An overexposure of sensationalism can cause investors to lose their ability and desire to hold securities full term. Don't fall victim to doing "something stupid," don't be greedy or fearful, and stay in the game for the long run. You can't play in the "BIGS" until you learn to hit a curve ball…you won't hit any curve balls unless you're in the batter's box.

CONSISTENCY…

There will always be traders and investors. Life would surely be a dull event without both breeds. Although I fit the definition of an investor, I also think of myself as a saver. I don't have many traders as clients; however, those that I do have a relationship with, I thoroughly enjoy. They think differently than I do and I get a kick out of following their thought processes. I recently read THE ART OF THE DEAL, an autobiography by Donald Trump. Mr. Trump is considered one of the major wheeler-dealers of our time. He has earned that reputation through aggressive deal making. His book chronicles one financial triumph after another. Mr. Trump emphasizes his acquisitions and what he projects to be their future potential; very few have been sold. The hype on the book jacket makes no mention of the man being an investor, to say nothing of being a "saver." Although he seems to fashion himself as an investor, he has all the qualities of a trader. Regardless of how flashy and outspoken Trump is, he is a very consistent man. Consistency is of great value to investors, it does traders little harm.

My tenure in the financial industry has allowed me an opportunity to look inside a variety of customer portfolios. The common thread that links all the successful investors is their ability to accumulate assets. Very few wealthy people own a lot of cash; their money is invested in financial assets, use assets or working assets. How are these fortunes amassed? The same way a building is built, one brick at a time. The family patriarch who possesses a net worth of many millions probably didn't wake up one day and invest all those dollars in their current assets. The more likely scenario is a systematic allocation of cash flow into stocks, bonds, real estate, etc. In order to do this, the assets you choose need to fit a long-term plan. That plan then has to be executed. Consistent execution of a long-term plan requires a Herculean effort from the average investor.

It never ceases to amaze me how the small investor shies away from the market when prices go down. If you are shopping for toothpaste at a drug store, there is "some" price that will cause you to buy an extra tube and "some" price that will cause you to switch brands or drug stores. Price gyrations in the market place cause investors to act like they don't need to brush anymore. When prices go up, investors warm to stocks and bonds and purchase them at incrementally higher prices. I am sure that greed is the motivating factor here. Likewise, as prices drop, the little guy shies from the stock market and eventually spits out his equities at prices he should be using as buying opportunities.

Bear in mind that the sensationalists in the media are telling these little guys what a swell deal stocks are when the market is going up. That same little guy will listen to the same source telling him that the marketplace is no place for the small investor when prices are going down. You don't have to be very intelligent (there's that word again) to figure out that the press will print whatever it takes to sell newspapers and magazines. How do we avoid these pitfalls? Be consistent in your approach to the markets. We have already decided to be intelligent (don't do anything stupid). Now we want to behave that way systematically. If you have decided to hold mutual funds long term, do so. If you have decided to buy municipal bonds with your excess cash flow, do so. If you want to add to your stock positions from time-to-time, you should welcome lower prices to do so. I suggest you regard lower stock prices as "toothpaste sales" and price appreciation as opportunities to take profits. As you can probably tell, none of this advice will be of much use to the day-trader types. It is my opinion that unless you think in terms that embrace investment cycles, three to five years, you can only hope to be lucky.

Before moving onto a discussion of quality, I would be remiss if I didn't address one of my favorite categories of investors: the retiree. These guys have the free time they've been looking forward to for years, a nice nest egg and friends with common interests to spend time with. Unfortunately, many of these retirees inherit the responsibility of investing their retirement funds when they leave their employer. To many, this is a huge undertaking and more stress than they need in their retirement years. Do yourselves a favor; be consistent and invest your money in the same manner it was invested while you were earning a wage. If your retirement account was 50% equities and 50% fixed income, make your rollover investments fit a similar mold. If you are fearful of losing your nest egg, pull your horns in a bit and choose a 40/60 mix. Don't jump from a balanced retirement account into a bank money market fund. You won't be happy if the equity markets pass you by. You also won't have a hedge against inflation and virtually no growth in your assets. Dance with the partner that brung ya! An intelligent consistent approach will always reap dividends over a complete investment cycle.

QUALITY…

All of us are now intelligent, consistent investors who are obviously halfway down the road to a major triumph over sensationalism. Quality should be a snap. All I have to do is advise everyone to buy government bonds and we can move right along to patience…right?…wrong! Our approach to quality will be to view it as a relative thing; a synonym would be the term "value." An investor who is completely risk adverse and has no desire for any growth should, in fact, strongly consider government bonds. However, the mainstream of the investing public does have a desire for growth and generally shuns the idea of earning at the lowest rates available in the marketplace. For these investors, we need to build a method of determining quality. Once an asset fits our quality tests, it should become a vehicle that allows the investor to be consistent in his approach to the marketplace.

I dislike the idea of leaning on rating agencies to determine the quality of a given security. I value their opinions, but only after the security passes my own tests. Since these tests vary with the class of security being considered, it makes sense to list the basic categories and explain what I look for in each.

- *Government bonds* - These securities represent a no-risk promise to pay by the federal government. I particularly favor their use when investing in zero coupon bonds.
- *Federal Agency bonds* - The Federal Home Loan Bank, Federal National Mortgage Agency and Federal Farm Credit Banks all provide federal assistance to sectors of our economy that couldn't function without them. Since each of these sectors of

the economy are unable to function independently, it doesn't surprise me when the respective federal agency experiences financial difficulty trying to make them work. I am not afraid of any of these. I believe they are there because the federal government wants them there. Once in place, these agencies will pay their debts. I consider them worthwhile investments for people who want taxable income.

- *Corporate bonds* - The rash of corporate takeovers during the 1980's was largely financed by "junk bonds." These securities are created during a takeover or LBO. I see no reason to invest in any of these newly created junk bonds. Unfortunately, the outstanding debt of target companies is often downgraded by the creation of junk bonds. As a result, there are very few corporate bonds that are not vulnerable to credit deterioration as a result of LBOs and takeovers. I choose to avoid corporate bonds that don't represent a company that is for some reason exempt from being a victim.
- *Municipal bonds* - I like to invest in munies that finance a project that people cannot avoid using. The best examples are found in water supply systems, sewer systems, electric systems, toll roads, toll bridges, and airports. The standard school bonds and GO bonds are obviously acceptable but penalize the return offered to the investor. There are several industrial development bonds and hospitals that have passed muster for me also. Of particular interest is any bond that has a sinking fund.
- *Common stocks* - There are several stocks that possess a good franchise, are easy to understand, and qualify as good businesses. Examples include newspapers, regional telephone companies, TV and radio companies. The best source for an easy to read discussion on this subject is THE MIDAS TOUCH by John Train. This book details the career of Warren Buffet, clearly a genius in his own time. I also favor "value" plays in high quality stocks. From time to time, the investor can buy a share of stock for less than the company's book value or liquidating value…that is always of interest.
- *Mutual funds* - There are a host of good ones. I see little value in the exotic hybrids that concentrate an investor in precious metals, foreign securities, oil stocks, etc. I do favor using funds that invest in high quality stocks and bonds. Mutual funds are an over-researched sector of the market place. Too much press is given to the current winners, with too little prognosis for the next winners. Too much effort is spent on trying to find the lowest front load and the skinniest management fee. As is true with anything else, you usually pay for what you get.

Please note that all of the criterion I have offered here are very simple. They appeal to the investor's basic intelligence (there's that word again) and don't require a rocket scientist to analyze. What the reader should learn from this section is that securities are living, breathing enterprises that have personalities and futures. The more we learn about the basics of any security we own, the less we regard it as a piece of paper or a line item on a brokerage statement. You should understand why you own the securities that you own and you should want to own them. If you own a stock that you like, you stand a much better chance of holding that security through poor markets and tough economic periods. I own the companies I do because they are great companies and I genuinely like owning them. Their corporate images are positive and I enjoy being part of their business enterprise. My kids always ask me if we're out to eat if the restaurant is one of ours, same with when we're buying products. As a result, I will own these stocks much longer and more profitably than I would a company that I don't understand and may not like.

PATIENCE…

It was June of 1975, two days into my second trip to New York. I was working for the First National Bank, piggybacking a delayed honeymoon with a business trip. My wife of three months was standing next to me in the Chase Manhattan trading room. We were impressed with all the goings on when a trader, whose age I would guess to be around forty, stood up and snapped "You own 'em" into the receiver and hung up his phone. This guy had just sold over $5 million in securities!

"I just didn't want to be long over the weekend!" he said to my friend Peter as he marched out the door. That incident has obviously stuck with me; unfortunately, I've seen it repeated countless times since. I'm sure such emotional behavior can be rationalized by other "trader" types. It certainly isn't the by-product of intelligence, consistency and quality. Patience is perhaps the most difficult-to-master quality we have discussed. The old sage in the TV serial Kung Fu used to extol his protege "patience grasshopper"…I think of that from time to time. Most investment cycles last from three to five years. I'm more than happy to wait that long for the types of returns I know are available from quality investments. One short-term decision makes the next one all too easy to make. I love the one liner "don't be short term greedy…be long term greedy!"

If you had purchased 100 shares of IBM when it first went public, your net worth would exceed $1,000,000 today. The same trade using McDonalds stock would net you $450,000. School is still out on Berkshire Hathaway; who knows where it's legacy leads. Heard any of these stories? I've heard a lot of them. Most are told by people who failed to execute the opportunity. In order to enjoy the profit described on the McDonalds trade, your holding period would have eclipsed the Cold War, Cuban Missile Crisis, Vietnam War, two Arab oil embargoes, 22% prime rates, Watergate, a junk bond investment bubble and that minor -508 day on October 19, 1987. Since IBM went public before 1920, we can throw in a couple of world wars, another crash, and the depression of the 30's for those investors. Some would argue that picking these stocks was just as difficult as holding them for an extended period. That's true, but I'll guarantee you that more people picked 'em than held 'em.

I have purchased a lot of lemons in my time (sad but true). They are very easy to identify once they live in your portfolio. When the market goes up, they go down…when the market goes sideways, they go down…when the market goes down, they really go down. I sell these securities and take my lumps. A good stock is equally easy to recognize. It goes up when the market goes up and goes down *less* than the market when the market goes down. A stock like this often goes up in sideways markets. When I own a stock like this, I generally add to it. When it offers me an opportunity to take a significant profit, I sometimes take advantage of that by selling *part* of the position. By doing this, I satisfy my greed emotion. (I admitted to feeling that emotion early on!) Sometimes the stock goes down and I buy the shares back cheaper, but not very often. The usual scenario is to see the stock price continue to climb. For me, that's OK; I've taken a profit and I still own an investment position in the stock. I wish I could call all markets correctly but I can't. I can develop patient long-term trading patterns that work for my customers and me.

The partial sale of a position sometimes acts as a relief valve, allowing the investor to hold the balance of the position long term. Cowboys like to shoot, lawyers like to sue and investors like to book profits. It is almost impossible to resist all these human failings. (I'm not sure taking a profit is a failing!) Exercise your emotion with intelligence and consistency. These qualities will predictably complement your patience.

ONE LAST STORY…

In the early 80's, the IRA deduction was expanded and all the mass merchandisers of stocks and bonds sold the concept of compound interest from January to April 15th of every year. It was about this time that insurance companies became brokerage houses, banks became purveyors of mutual funds and brokers became bankers. The public thought it was great. Every wage earner was the subject of an advertising campaign; every bridge club had a broker. Housewives and husbands spent days finding vendors with the lowest service charge and highest rates of return. President Reagan's sweeping tax reform in 1986 eliminated the IRA as a tax deduction for a high percentage of the electorate. Few customers now inquire about the desirability of an IRA. End of and era?

Let's go back to the early 80's. Assume you opened an IRA with a broker and invested the $2,000 non-spousal contribution in a 25-year, zero-coupon Treasury bond. Interest rates were double digit at the time but our assumption will be a rate of 9.00%. That transaction would be worth $18,065 to you at maturity, not considering the tax benefit a deductible IRA offered at the time. Since this is a pretty easy way to provide for one's retirement years, I recommended it then and I continue to recommend it today. The punch line to this story is that every wage earner in America can still take advantage of this transaction…the tax code permits every wage earner to invest in an IRA, only the deductibility of the contribution has been altered. Why aren't banks, S & L's, insurance companies and brokers promoting these accounts? They are but to a much lesser degree. The bottom line is that this transaction now requires a more sophisticated investor (saver). Since the IRA account is no longer like shooting fish in a barrel, it doesn't receive the sensational advertising it once did.

Those of us who continue to invest in non-deductible IRAs epitomize the ICQP (intelligence, consistency, quality and patience) investor. The desirability of these accounts has been sadly tainted by their lack of appeal to a sensationalizing media. An IRA no longer hits the everyday man's greed button. Unfortunately, it doesn't possess anything to really be afraid of. As a matter of fact, it now ranks only as a "good" investment. Result: No attention from the guys who buy ink by the barrel.

Hopefully, the reader is able to put together some of the pieces at this point and draw the obvious conclusions. Sensationalism in the media is public enemy #1 for the little guy in the marketplace. We will never eliminate it. Honesty and candor will never sell as many newspapers as hype. The date of this writing is September 1988. With its one-year anniversary at hand, we are about to be besieged with TV specials and emotional epistles trying to explain the crash of '87. The same thing will happen next year and for as many years into the future, as long as it "sells." Concurrently, market gurus will ponder the question "when will the individual investor regain his confidence in the marketplace?" Not a valid question…confidence was never a widespread emotion…greed was! You can't recover something that you never had.

During the months prior to the crash of '87, "speculative" investors allowed their normal fears to be overwhelmed by the joy of their greed. During the crash, fear became the dominant emotion in rather short order. The value of securities, as measured by the Dow, was greedily high in August (2700) and fearfully low by October (1650). True investors had the kind of confidence that is born of intelligence, consistency, quality and patience. The media will someday allow us to believe that the individual investor has returned to the marketplace, restored his confidence and as a result, all is well in "sensational land." Us guys in the "in-crowd" will understand the reality of the situation; it's as easy as ICQP.