



AndersonGriggs

“Common Sense Investing for Intelligent Investors”

Monthly Letter to Our Clients and Friends The Battle for Investment Survival Our Five Year Forecast

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Complimentary Copy

The Battle for Investment Survival

In 1935, a thirty-six year old bond salesman took it upon himself to rebuild the average American's confidence in the wonders of owning common stocks by writing a short 153 page book titled, *The Battle for Investment Survival*. **The book originally did not sell very well, but its author, Gerald Loeb, was a salesman who would have rivaled even the best the world could offer today.** He was handsomely rewarded by the direct mail promotion of his book. The first edition of *The Battle for Investment Survival* was reprinted on twelve different occasions and sold over 250,000 copies. When the average investment book has a hard time selling more than a few thousand copies, Mr. Loeb's can easily be considered a classic.

My copy was published in 1966 and includes the original 33 chapters, with an additional 45 chapters written by Mr. Loeb from 1936 to 1965. **You will not find in-depth analysis or higher level mathematical equations within the book, only simple commentary that is both easy to read and easy to understand.** In 1935 the world of investors needed a Gerald Loeb. Many professional investors have criticized Mr. Loeb as being only a salesman who simply wanted to drum up business for E.F. Hutton. We believe that his words encouraged individual investors to own common stocks at a time when the masses were terrified of the markets, which we all know to be the best time to buy.

Today's financial journalists owe a great deal to Mr. Loeb, as do the majority of brokers and financial planners in business. He created the mass market for investment books and investment commentary. He was said by *Forbes* magazine to be “the most quoted man on Wall Street”. As the voice of E.F. Hutton for over 40 years, he set the stage for today's financial planning industry, advocating that brokers should not just study the market, but should also become experts on taxation, real-estate, and insurance.

Today is not unlike the period of Mr. Loeb's rise to fame. We are living in the remnants of the "Great Recession" and the subsequent market crash of 08 and 09. Most individuals are terrified of common stocks today. And given their recent history, we easily understand. The headlines are dominated by doom and gloom economists, and the politicians who have accepted their teachings as reality. The world is hungry for a new Mr. Loeb, and we hope that he or she soon arises.

For us, the battle for investment survival is real and now. We could sit back and pretend it is not real in hope that it will go away, or we can do what I believe you expect from us- question every aspect of our investment philosophy and processes and make adjustments as needed... to not only win the current battle, but to win the war.

It is important to remember that battles are relatively short in nature. They are numerous and can be won or lost due to a single event. As in all battles, understanding your opponents' strengths and weaknesses is a necessary first step in planning a winning strategy. If your opponent changes during the course of battle and you fail to recognize or accept that change, you could quickly end up a prisoner or worse. **Not wanting to end up a prisoner of this war or worse, I wanted to share with you some thoughts on the changes that have taken place in the market and how we are using those changes to our advantage.**

The Market is Different

In our early years the market was pretty simple. It was real people who owned individual stocks or bonds and their buying and selling was typically driven by just two motives. The first was the need for cash for spending purposes. The second was based on a fundamental valuation model where they either thought of their investment as over or under priced. There was a direct connection between the owner of the investment and the business that either paid them interest or shared their business success through dividends and capital growth. Having this connection between the principal owner and the business created a less volatile marketplace. I could assure myself that if prices fell too far out of fear or rose too high out of greed those fundamental investors would quickly arbitrage the difference away. **Fundamental investors are still here. After all, I consider myself one. The market, however, has two other core groups of investors who could care less about fundamental valuation.** They are the index investors and the momentum investors. The two combined, I'm afraid, are influencing the markets to a greater degree than the fundamental investors. The result of this influence is a substantially higher level of price volatility.

Index and Momentum Investors

I consider Jack Bogle to be the patriarch of index investing. His championing of the S&P 500 index fund allowed it to become available for the average individual investor. For more than 30 years he has been constant in his belief that indexing is the method most individual investors should use for their common stock investing. The statement on the inside flap of his book, *The Little Book of Common Sense Investing* explains the logic:

“Investing is all about common sense. Owning a diversified portfolio of stocks and holding it for the long term is a winner’s game. Trying to beat the stock market is theoretically a zero-sum game (for every winner, there must be a loser), and after the substantial costs of investing are deducted, it becomes a loser’s game. Common sense tells us—and history confirms—that the simplest and most efficient investment strategy is to buy and hold all of the nation’s publicly held businesses at very low cost. The classic index fund that owns this market portfolio is the only investment that guarantees you with your fair share of stock market returns.”

For many years this approach has done exactly as Mr. Bogle promised. But those historical returns of indexing were earned in a period of time when fundamental investors were the majority. It was the fundamental investors that sought out efficient pricing. Today, however, because of the huge popularity of indexing, the efficient pricing mechanism of fundamental investors is no longer in the driver’s seat. Years ago, when indexing was accumulating a following, I was asked in an interview if this movement would make the job of selecting investments harder. My answer was no, it would actually make our job easier. My reasoning was very simple. If everyone indexed, then the only changes in the market price would be the result of cash flow. Prices would only react to the flow of money... and money flow is based on fear and greed, so all we would have to do is be a bit contrarian to outperform.

Momentum Investors believe a security price that is rising will continue to rise and a price that is falling will continue to fall. This is the basis for most technical analysis. If you hear someone mention the 50 day moving average, or the 200 day moving average, you are listening to a momentum investor. Charting is the tool used by most momentum investors and can be quite persuasive to individuals and professionals alike. The influence of momentum investing has gained in popularity immensely over the past decade, especially with traditional financial news programming. There is a very good reason why this is so. Investment programs are on 24 hours a day. Discussing the fundamentals of a company is boring. The media needs excitement and entertainment to last. Charts and the accompanying discussions meet those needs.

Common Sense

We have used the tag line “common sense investing for intelligent investors” or a slight variation for many years. **We define common sense as “looking at things the way they really are, and not as we hope they will be”.** Failing to recognize that momentum and index investors have

taken a more prominent role in setting securities prices would violate our own definition of common sense. We can choose to ignore them however, because we believe that in the long run the market will capture the growth of capital, giving fundamental investors a substantial return that exceeds both index and momentum investors. This, however, creates another problem. **One year after Gerald Loeb printed his book, the economist John Maynard Keynes published his *General Theory of Employment, Interest and Money*. He explained the problem very well with this quote (p. 157):**

If the reader interjects that there must surely be large profits to be gained...in the long run by a skilled individual who...purchase[s] investments on the best genuine long-term expectations he can frame, he must be answered...that there are such serious minded individuals and that it makes a vast difference to an investment market whether or not they predominate... But we must also add that there are several factors which jeopardize the predominance of such individuals in modern investment markets. Investment based on genuine long-term expectations is so difficult... as to be scarcely practicable. He who attempts it must surely... run greater risks than he who tries to guess better than the crowd how the crowd will behave.

From 1930 to 1960 the majority of investors followed the trading techniques pushed by Gerald Loeb and the philosophy exposed by Keynes. The sixties were dominated by the momentum guys while the 70's and 80's were run by the fundamental guys, predominantly lead by Warren Buffett and other followers of Benjamin Graham. For the last twenty years, the markets have been driven by modern portfolio theory (MPT), heralded by a few economists out of Chicago. **Beginning with the technology crash of 2000, followed by the housing bubble of 2008 and the subsequent financial fiasco, the markets pricing mechanism seems to have returned in favor of non-fundamental investors.**

Benefiting from this change

Last month I was interviewed by Seeking Alpha, one of the more successful (with an estimated 4 million viewers) financial media web sites, for their "Just One Stock" series where I discussed the volatility of stock prices directly due to index fund mechanics. What I said follows:

The price fluctuations are a result of the mechanics of index funds, and to a lesser degree the liquidity requirements of actively managed funds, independent of company fundamentals. To emphasize this lets look to the father of index funds, Jack Bogle. In a recent interview with Tom Keene and Ken Prewitt of Bloomberg News, Mr. Bogle stated that the SPDR S&P 500 ETF (SPY) had a 10,000 percent turnover last year. Turnover of that magnitude has nothing to do with the fundamentals of the 500 companies within the index. Yet the mechanics of the fund require the buying and selling of all 500 companies. This is truly a case of throwing the baby out with the bathwater when selling

takes place, and scrambling to buy every baby in sight when the money starts flowing back in. It is this pressure on pricing that comes from the required buying and selling that we are taking advantage of.

In order to take advantage of this volatility we have been working hard over the last few months to conduct a complete review of our processes of how and why we construct portfolios the way we do, as well as the research on each individual security. Our opinion from this review is that our basic portfolio construction process is appropriate and major changes are not necessary. However, as to the individual securities, we have found a need to be a bit more active in the establishment of buy and sell prices. Volatility is a two way street. Prices can decline faster and to a greater degree than fundamentals warrant. Patience is required while we wait for prices to decline to a true bargain price before adding a new security to our portfolios. At the same time prices can rise well beyond reasonable value. Our thoughts will be concentrated on selling at a fair price without trying to pick a top. We have no way to determine how long this excess volatility will last. As we implement these changes you may find that our cash levels are higher than those we have held in the past, and your portfolio may look a little more contrarian than it has in the past.

We have to admit that the high level of volatility in security prices may not last as long as we think it can. A new bull market is possible as the world finds a bottom to the deleveraging that is taking place. Let's hope that it doesn't take that long.

Our Five Year Forecast – A Tribute to John Maynard Keynes – “In the long run we are all dead.”

Many forecasts, including ours, may be quite useless and an exercise in futility. But we, like everyone else who has excess funds, must formulate some expectations of the future. The short term may be dominated by non-fundamental investors, but any long term forecast must be drawn from fundamental data to have any validity. When all is said and done, investing is simply a matter of choices as to where we place our investable funds. We can lend our funds and charge rent (interest) for the use of those funds, or we can share in ownership and be rewarded by the growth or punished by the loss of our capital. In each case, we need to have some basis to make a decision as to the amount of money we are willing to rent, or the amount of money we are willing to deploy for capital growth.

We are including in our forecast some additional work that we complete for each of the major economic sectors as determined by the stocks included in the S&P 500. Because of the number of tables included, we have decided to add this year's updated forecast as a supplement to our letter. My hope is that you will find it more useful and easier to use.

Until next time,

Kendall J. Anderson, CFA

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