

Monthly Letter to Our Clients & Friends

Thinking Long-Term

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Complimentary Copy

An Anniversary!

My wife and I celebrated our wedding anniversary on September 24th with a weekend trip to Ashville, NC. A trip a hundred miles from home may not seem like such a grand event for as many years as we have been together, but, given the illness of the stock market and Kathy's need to help a couple of kids at school, a weekend was all the time we could spare.

An anniversary is a celebration that lends itself to a little reminiscing of time past. I couldn't help but think of the very early years of our marriage. If I was able to listen in on the conversations from our families and friends I am sure that I would have heard a similar theme: What a mistake! How do they expect to support themselves?! Married – their just teenagers! There is no way they will stay together for more than a year or two. I thought they would do more with their lives, go to school, and get a good job— now that's impossible!

To stir up a little more despair with our family and friends, our first child was born within a year. This made even better conversation, because we had broken all the rules, a teenage marriage, teenage parents, no college and no trade. **YOU HAVE RUINED YOUR LIFE!!!** (was the common assumption.)

I thank God that we never heard their conversations; we might have decided they were right and given up all hope. But as it was, we didn't worry about what they were thinking. After all, this is America, and all we needed was each other and the need to support our growing family. America gave us this opportunity. That same opportunity is still alive and well in this country. It pains me to see the young people of Occupy Wall Street camping out in the parks of major US cities. Some are there simply for the party, but there are a few that have given up hope. If I could send one message to them, it would be to recognize that this country is still the land of opportunity and all it takes is for them is to accept it. If they have the will; this country still gives them a way.

The Biltmore House

In Ashville we visited the Biltmore House, the largest family owned home in America. Built by George Vanderbilt III, son of William Henry Vanderbilt and Grandson of the “Commodore”, Cornelius Vanderbilt opened its doors in 1895. The house originally sat on a 125,000 acre estate and includes 250 rooms, 34 bathrooms and 65 fireplaces. If you ever get a chance to visit Ashville make sure you take the time to take the tour of this magnificent home.

Most of you know that there a just a few ways to gain wealth. You can inherit wealth, you can marry wealth, you can be exceptional at your trade like an athlete, an actor/actress or a top corporate executive, or you can become wealthy by owning and operating a growing business, which is by far the way the majority of wealth in America is created. George was one of the lucky ones; he, like his father, inherited wealth. Grandpa, the creator of this great wealth, was anything but a fine, country gentlemen. He created his wealth through any method he could, including stock watering, bribery and stock corners (all of which are illegal today). He quit school at age 11 to work on his father’s ferry. At age 16 he started his own ferry company, transporting freight and passengers between Staten Island and Manhattan. He married his first cousin, fathered 13 children, and along the way built one of the largest transportation companies in the world. **When he died in 1877 he controlled 1/87 of the entire GNP of the US. Today that would be equivalent to \$161 Billion.**

Daniel Drew, a tough guy himself, and the first of the world’s takeover artist, learned the hard way not to mess with the Commodore. The story is told by Ken Fisher in his book 100 Minds that Made the Market:

The Commodore taught the financial world how to corner stocks, something illegal these days. But back then it was quite a feat. In 1863, when the Commodore first started buying railroad stock, he was practically laughed off Wall Street. They saw an old shipping magnet who knew absolutely nothing about the rails and, to top it off, he was buying up the depressed Harlem and Hudson River lines! Let them laugh, Vanderbilt roared—he never gave a hoot for public opinion. He gained control of the two lines in hopes of merging them. Then he set about getting what he wanted, obtaining a charter from Manhattan policos through bribery to connect the Harlem line with city streetcars.

As a result, the stock zoomed, attracting Daniel Drew and the same city politicians. Licking their chops, Drew and his corrupt cronies sold Hudson short, then prepared to renege on the charter, while the old Commodore bought all he could. When the streetcar charter was canceled, the stock dropped and Drew’s group further sold short at 75—but when they tried to buy back their stock, the found Vanderbilt had cornered it! Harlem jumped to 179 and Vanderbilt settled at top price, letting the group off the hook for a million and Drew, \$4 million.

Wall Street still giggled at him—but not after 1864! As state legislators considered a bill allowing his Harlem-Hudson merger, they pocketed his bribes. Then, sniffing quick profits, they

called in Drew to lead them in again selling the Harlem short at 150. The bill was naturally defeated, causing Harlem to plummet. Drew's group waited until it reached 50 before covering its shorts. Meanwhile, as it fell, Vanderbilt bought and bought until he had accepted 27,000 more shares than actually existed. He had cornered Harlem again!

The old commodore whistled to the defeated Drew, "Don't you never buy anything you don't want, nor sell anything you hain't got!"

Almost 150 years have passed since the Commodore spoke these words, but they still have meaning today for all investors. Buy what you want to own and never, ever, sell short.

These words are in direct conflict with the current theories that so many have bought into. Trading stocks is the road to riches! You can make money if the market goes up and you can make money when the market goes down, all you need is the latest and greatest program to show you how. All you need to do is believe in the economist's version of portfolio management, Modern Portfolio Theory and its indifference to selling short or unlimited borrowing to make superior returns.

A Long-Term Investment Success

Justin came into my office the other day looking worried. As you know, Justin has worked with me for the last eight years—talk about training under fire. He had just completed a portfolio review for one of our long-term clients. He was concerned that we had an incorrect cost basis on one of her holdings that could affect her tax planning. **Since he has not seen very many good times I reassured him that the cost basis was correct, and yes, she did have a profit that exceeded ten times her original investment. Ten times without reinvesting dividends in 16 years!**

Yes, I reassured him. But you will not see that very often because it is the exception, not the rule. This particular stock's value has fluctuated over 30% every year since its original purchase including many years where the value declined by over 50%. Very few people have the stomach to handle this much volatility! He then pressured me to find out how she could have held on with this much volatility. **I couldn't answer that for him, but over the years I know that she just believed she was an owner of the company and the market price was unimportant to her as long as the company kept growing and paying her a good dividend.**

History Is On The Side Of Long-Term Investing

As long as the company keeps growing and continues to pay dividends! Don't never buy anything you don't want, nor sell anything you hain't got! It seems that very few people follow these words of wisdom today. A quote from the great procrastinator, Aaron Burr, shows much relevance in regards to common stock investors: "Never do today what you can put off till tomorrow. Delay may give clearer light as to what is best to be done".

Delaying what you can do today is not a code to live by. But when it comes to an emotional response to market volatility, not reacting by buying or selling has a history of being the correct approach. From July 1st, through September 30th, the stock market as measured by the S&P 500 declined 14.3% excluding dividends. This is the worst three month performance in years and its decline drove many investors to sell all their stocks. Most of those that sold were reacting to the price decline only, paying no attention to the growth of earnings or dividends. I am sure a few are wishing they had delayed their decision to sell. Because from September 30th through October 14th, the S&P 500 has gained 9.03% and finished the week just 2.6% below where it began at the first of the year. Yes, this is down a little, but nothing that should create panic. In fact, this decline and recovery is not abnormal at all.

I know many of you may be saying, “This time is different”. This time the European banks are all going to bust and take America down with it. This time, China’s growth rate is coming down and with it every company in America. This time the U.S. has been downgraded, the housing market is still a mess and no one can find any work—America is doomed!

How easy it is to lose faith in the future of this country and its businesses. Last year, the market declined by 16% in a couple of months with the flash crash, creating the greatest one day “fluctuation” of stock prices ever in the history of the Dow Jones Industrial Average, only to end the year with a very good rate of return.

And what about 2006 when war broke out between the Hezbollah and Israel? The worry over oil prices, the fear that the middle-east will blow up and the rest of the world will follow. The market was telling itself, “This time is different” and promptly sold off by over 7% in two months before gaining 13.6% over the next 18 weeks.

From 1998 to 2003 oil prices had been under control. In 2004 prices began to rise from \$25 to a new high. Wouldn’t this stop any chance of a recovery in our economy? The market rose 10.9% in the last seven weeks of the year.

Do you remember 1996? In December the then Federal Reserve Chairman gave his famous speech using the phrase “irrational exuberance” to describe the stock markets 15% run up from August through November. After an initial decline in prices (after all, the Chairman of the Federal Reserve, the most respected economist in the nation at the time, said stock prices were too high relative to earnings) the market return was 33% over 18 weeks in the summer of 1997!

Does this mean you should never react to news that impacts the short-term price swings of common stocks? Obviously, the answer is no, but the news that you react to should be based on the companies you own, not the masses. This will make you concentrate on the long-term and resist the predisposed human characteristic of short-termism.

John Bogle published a paper in the Financial Analysts Journal (2005) discussing the impact on returns caused by excess trading. Of course he was concentrating on the cost impact due to trading, but he also shared in his paper the impact of market timing caused not by professional managers, but by the individuals who invest in the funds. **He showed that from the beginning of the great bull market in common stocks in 1983 to 2003 after the internet bubble popped, the S&P 500's annual return averaged about 13% net of all cost. The average U.S. equity mutual fund averaged just 10% over the same time period. But get this, the average mutual fund investor averaged just over 6% during the same time period. This is possible, because investors themselves or their advisors reacted to short-term price changes, buying and selling on news, fear, or greed.**

Conclusion

We will never be able to remove all the news that influences our investment decisions, nor should we. What we can do is recognize that rapid trading and market timing may work in the short-term, but has reduced individual returns over the long-term. We can recognize that markets regress to the mean over long periods of time, but that may be much longer than you have or want.

Our approach is an attempt to reconcile the two. We are fully aware that at times, stock and bond prices exceed value and at other times they are well below value. **Currently, bond prices are well in excess of any value while stock prices are still a good discount to the value of the underlying businesses they represent.** If regression to the mean continues to hold true, then bond investors will suffer in the future while common stock investors should be rewarded.

Our portfolios are structured for this, holding larger than average cash balances and bonds or CDs with very short-term maturities and a good dose of common stocks up to the limits that you, our client place on us.

Until next time,

Kendall J. Anderson, CFA

P.S. If you are wondering how two people can stay together for 40 years I am afraid the only answer I have is, "It was easy for me - just visit with Kathy for a little and you will know why". The question you should be asking is, "How could Kathy put up with me for those 40 years?"

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