

Fear and your financial future

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In this article, Paul Merriman addresses some of the fear-based questions that arise for many investors during tumultuous economic periods.

Should I move all my money to gold? Is the government leading us into another depression? Should I ditch buy-and-hold and become a market timer? What will be the effect of the stimulus plan? When will things turn around?

It's not easy being an investment advisor these days and being expected to know all the answers. Here are some more things we are being asked: If bonds are making money, should I sell all my equity holdings and invest only in fixed-income funds? Shouldn't I invest exclusively in cash until things get better? Should I stop taking income from my investments to keep from going broke? Is this a Japan-style collapse? What happens to my investments if we get into high inflation?

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Whew!

In a nutshell, the answer to each of these questions is that nobody knows for sure. We are navigating in uncertain waters without a reliable marine map into the future.

As you might expect, I have spent considerable time thinking about these and other questions that affect our clients and all other investors. I think it boils down to this: Who are you going to trust for answers?

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I think we have four main choices of where to look for answers. We can trust Wall Street. We can trust Main Street. We can trust the financial media. Or we can trust the academic community. Let's look at each one briefly.

Wall Street

The collective wisdom of Wall Street institutions has brought us to the mess we are facing today. Certainly corporate and individual greed as well as government policies have played a major role. But Wall Street has been busy over the past few decades inventing, marketing and selling all manner of products. Some of them have become so complex that not even the smartest people in finance

knew what they really were – until they started blowing up last year.

Brokerage houses and many large fund companies claim to have found the best managers, the best strategies and the best products. When one set of solutions doesn't work out, another pops up quickly to replace it. Right now, Wall Street firms are seriously hurting for business. They want more than ever for you to do something that will generate commissions. Without commissions, paychecks and bonuses disappear.

But as we have said many times and many ways, Wall Street usually has a conflict of interest with

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investors. Investors need solutions that are easy to understand and easy on the pocketbook. Wall Street has found that it can charge larger commissions by investing more-complex products that carry higher levels of risk. We have seen

where such products can lead – to international crises.

For all these reasons, I don't think Wall Street is the place to go for reliable answers to investors' current questions.

Main Street

What is "Main Street?" In this discussion, it's your neighbor, your colleague, your relative, your friend or (particularly influential for some reason) the person who winds up sitting next to

you on an airplane. Perhaps it's somebody you know who is in an investment club. Some of these people may be knowledgeable and savvy, but you probably have no way to evaluate that.

Main Street is never short of opinions, often spoken with authority and even bravado. Your neighbor or old buddy from school days may tell you his portfolio is built on only three stocks, and (of course) they have all done tremendously well. Once in a blue moon, this buddy might show you investment statements to back up his claim. But probably not, because those statements may also contain evidence of all the mistakes he made along the way.

Main Street, in short, relies on amateurs for information and advice. If your money doesn't matter to you, it's a very convenient place to turn for answers. But smart people don't rely on amateurs for medical care. They shouldn't rely on amateurs for their financial health, either.

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Financial media

The broadcast and print media seem to be on your side, analyzing things for you and bringing you the insights and advice of the best brains in the business. This is certainly what they would like us to think, and it's what most individual journalists aspire to. But as powerful business institutions (and that is what they are), the media have their own agendas. Mostly, they want to keep readers, viewers and listeners coming back

for more and more. This improves their ratings and attracts advertising.

To do that, the media must keep us surprised, annoyed, excited and on edge. (Think of that short list next time you watch Jim Cramer on TV.)

Education usually takes a back seat to entertainment. Readers, viewers and listeners who don't understand this are in danger of being misled. All you have to do is look at front-page headlines in past issues of the big financial magazines as they gushed over smiling star managers and strategists who were making people rich. In good times, this formula works well to sell magazines. These days, doomsday commentators are much more in vogue.

You can count on the media to play up what's currently hot, without much serious thought about what investors might really need to know.

If a story gets editors excited, if it's edgy, if it's something that nobody else has reported before, that story has a good chance to make it to the news, whether it's in print, on the air or online.

The media is not the best place to turn for reliable investment answers.

What you are seeing, hearing and reading was not selected according to how well it's likely to meet your needs, in other words. It was selected according to how well it is likely to meet the needs of the media. This is not the best place to

turn for reliable answers to the tough questions we are being asked.

The academics

Fortunately, plenty of academic research has been done over the past 50 or so years on what makes investors really successful. Academic researchers don't stand to make or lose money depending on what they learn. "Just the facts, ma'am" seems to apply to their work.

We trust the academics for their insight. As we have repeatedly written and said to anyone and every-

one who will listen, the academics by and large preach long-term mechanical strategies with low costs, low turnover and wide diversification. They have found in study after study that individual investors who make their own buying and selling and timing decisions get it wrong much more often than they get it right.

Along with the academic researchers, we believe that investors are likely to be most successful when they can remove emotions from the decision-making process. That of course is difficult to do when Wall Street, Main Street and the financial media are all stirring up the pot of fear, as they are this year.

We know that in the past, the American economy has faced great and grave dangers, and it has always come back. There have been disruptions, losses, pain and dashed dreams. But Americans are mightily resilient, and I don't

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think that has changed.

Now the questions, please

Based on the knowledge and beliefs that I've laid out so far, I'm going to give you the short answers to some of the questions we're being asked. If you're looking for full satisfaction, you won't find it here. Any full and useful answer to these questions requires a lengthy conversation. But if you want the honest, candid views of somebody who's been watching and helping investors for more than 40 years, read on.

Question: What will the long-term effects be of all the government borrowing and deficits? How will we ever pay for it?

My take: Check back in 20 or 25 years and I'll tell you the answer. Until then, nobody can do better than speculate. I am confident that if the govern-

If government programs are successful, the result will be a stronger economy.

ment's programs are successful, the result will be a stronger economy that will get consumers spending once again; that in turn will give us the opportunity to dig out from the current

mess. In the 1930s, the Federal Reserve did just the opposite of what it is doing today. New and inexperienced in regulating the economy, the Fed raised interest rates and cut off credit. Now, the Fed is trying to make credit easy in the hope that this will restart our economic activity.

Question: Is bank nationalization a step towards socialism?

My take: I don't have any reason to think there is any desire on the government's part to nationalize any bank except as a very temporary measure. So my answer here is no.

Question: Should I move my assets to gold?

My take: No. Gold has proved to be an unreliable and volatile store of value over the decades. In the mid 1970s at \$120 an ounce, gold was re-

garded as a "fringe" investment and few investors wanted it. The price rose to around \$800 a few years later (leading to eager buying), then lost much of that value. In the past year, gold's price has fluctuated

between \$650 and \$1,000. Over many years, Treasury bills have produced a similar long-term return to gold, with much less drama and much more stability.

Treasury bills have had much less drama and more stability than gold.

Question: What effect will the stimulus plan have on the stock market?

My take: You'll see it in the headlines every day. Wall Street thrives on certainty, or at least a future that is relatively predictable. We don't have that now, and "the street" doesn't know what stocks are really worth. This is leading to great volatility, which is unsettling. In the end, the

market is simply a snapshot at any given moment of America's collective mix of hopes, fears, greed and confidence. In 2009, this mix is changing almost every day.

The best academic evidence I know indicates that the major equity asset classes we recommend have an expected very-long-term return of about 1 percent a month. Eduardo Reppeto, chief investment officer and head of research at Dimensional Fund Advisors, spoke to our firm recently and predicted that once the market turns upward, the performance of these asset classes is likely to be more like 5 percent a month, continuing for many months.

Considering the current state of the market, that may seem unrealistic. But before you dismiss it, think about this little bit of history: After the market crash of 1929-1932, the Standard & Poor's 500 Index turned in a compound rate of return of 32 percent from 1933 through 1936. Among the equity asset classes that we recommend, we have data from those years for large-cap value stocks (up 34 percent a year), small-cap value stocks (47 percent a year) and the small-cap index (61 percent a year). The average of those asset classes was about 43 percent. That's per year, compounded, for four years. And this happened during the depression, before the economy had turned around.

If a similar pattern emerges this year, then the people who are invested now are the ones who will get that return, because they are the ones who took the risks.

Question: Is the government taking us into another depression?

My take: Certainly not if it can avoid it. Roughly

70 percent of our economy is based on consumer spending. I think that means that the slump will

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come to an end only after we collectively open our wallets again and resume spending. Ironically, the frugality that's good for each household may not be good for the economy. It will take awhile for us as a nation to sort this out.

Question: Is buy-and-hold dead?

My take: This topic is being tossed around quite a bit in the media these days. If we are talking about major equity asset classes like those we recommend, then I don't know of any evidence that buy-and-hold is "dead," whatever that is supposed to mean. We are in the midst of a major market correction, and we have had major corrections before. In every case, the market has eventually emerged stronger. In every case, the only investors who profited fully from the recovery were those who were invested when the recovery began. Those who bailed out and waited until the future once again seemed bright inevitably missed out on significant gains.

If this question is directed at individual stocks, then the answer has to be that buy-and-hold is dead. We've seen that with stocks of Ford and General Motors, Washington Mutual and Bear Stearns, and earlier with such giants as Enron

and Sears. Even General Electric, once among the mightiest of U.S. corporations, has been clobbered – losing 54 percent in 2008 and a further 55 percent in the first nine weeks of this year. Unfortunately, the past gives us no evidence that we can reliably identify the outstanding individual companies of the future.

Question: Should I abandon buy-and-hold to become a market timer?

My take: Probably not, and certainly not if you are thinking of doing timing on your own. However, if timing interests you, it's worth considering having some of your money in buy-and-hold and some in timing, as some of our clients do.

Consider having some of your money in both.

Embark on market timing only if you know exactly what you are doing and you're prepared for the challenges of timing, which are significant.

The purpose of timing is not to increase your returns, though in some periods it has done that. Its purpose is to reduce your risk, and it does that without question by removing assets in your portfolio from exposure to the market. Timing (like buying and holding) is a philosophical approach to investing for which there is no proof of future success. For that matter, the same could be said of investing itself.

Question: If the bonds in my portfolio are performing well, shouldn't I sell my equi-

ties and put everything in bonds?

My take: When you drive, do you watch out the windshield or lock your eyes on the rear-view mirror? Chasing recent performance is one of the habits of highly unsuccessful investors. If you have made money in bonds and lost money in equities (as most people have at this point), then you should be doing just the opposite of what you propose. In other words, you should buy low (stocks, now) and sell high (bonds, now). This is very difficult emotionally, and that's one reason so many people get investing wrong.

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Question: When do you think things will turn around?

My take: The short answer is that from what I know of the past, I think we are much closer to the bottom right now than we are to the top. The longer answer is that if I really knew the answer, I wouldn't keep it a secret. What if I told you that I knew for sure the bottom would occur on a certain date, say March 31? Would you take me seriously and invest all your money based on that? Not likely. If in the summer of 2007 I had predicted the present predicament and told you to sell everything, would you have done so after several years of making easy profits? Not likely.

What I can tell you is that I believe the people who have and keep money in equities now will

receive a very high premium for the risk they are taking. When will that be? See my “short answer” above.

Question: Should I stop taking income from my portfolio so I won't run out of money?

My take: You need to have a very frank conversation with your advisor based on your own circumstances. The laws of mathematics have not been repealed, and you need to match your withdrawal rate and your life expectancy with an asset allocation that will give you a piece of the action along with peace of mind. This is always a balancing act, and it's important to do it carefully. Professional help is highly recommended.

I've briefly covered a lot of territory here, and every topic is worthy of more discussion. But unfortunately in today's climate of fear, the questions and arguments can go on forever without any knowledge-based conclusion.

So I would like to wrap up this article by quoting Samuel S. Stewart, chairman and chief investment officer of the Wasatch Advisors and president of Wasatch Funds. In a letter to shareholders early in March 2009, Stewart wrote: “Unfortunately, our immediate gratification culture seeks immediate solutions with immediate improvements, and when they don't come, panic and fear win the day. It is times like these when perhaps we see the downside of our round-the-clock news cycle and constant communications. Our societal response to this crisis needs to be patience and creativity, not entitlement and fear.”

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