

# Current Observations

FINANCIAL & INVESTMENT MANAGEMENT GROUP, LTD. • FEE-ONLY WEALTH MANAGEMENT

## Sustainable Best Practices



by Paul Sutherland, CFP®

In previous newsletters I have referenced the philosophies and strategies of investment gurus like John Templeton and Warren Buffett. In this newsletter I want to explore further why FIM Group's investment management approach is rooted in the best practices of these investing legends.

### Thesis

The superior performance of proven private investors like Buffett and Templeton – and economic scholars like Benjamin Graham and Larry Ellison – can be distilled into a single, disciplined approach that captures the essence of their investment strategies. This approach is fortified by best practices that attempt to sustainably do one thing – *maximize benefits by using the following investment tools:*

- Diversification and concentration
- Conscientious security analysis
- A “price matters” orientation to capture excess returns

Money doesn't manage itself. Asset allocation, diversification, security analysis and capturing excess returns don't just happen. These tools require the “hands-on” management of a skilled, talented manager who can implement them with consistency and discipline, unencumbered by the four psychological poisons that can reduce investors' returns.

### Four Poisons

- Recency effect
- Endowment behavior
- Fear and inertia
- Narrow investment universe

These four poisons can create a “sell low and buy high” market pressure that compels undisciplined investors to deviate from their long-term strategies, thereby reducing their returns by a significant percentage (see FIM Group March and December 2008 newsletters – [www.fimg.net](http://www.fimg.net)).

### Investing Without Borders

The next element of successful best-practice investing seems so empirically logical and rational, but nonetheless it should be mentioned. Simply, one should invest without arbitrary restrictions. Long-term success depends on the flexibility of an unencumbered investment approach that completely avoids, for example, a country bias, region bias, asset class bias, market cap bias, etc. The root of such restrictions is an attempt to simplify a complex universe of investment options for the sake of making the management process “easier.” I equate it to the modern approach of “dumbing down” investing – aka laziness.

### Money Must Be Managed

Many approach investment management as a static system of indexing or passivity, but money doesn't manage itself. Countries, companies, societies, consumers and all the elements that drive financial markets are dynamic and ever-changing. Consider, for example, the historic opportunities to preserve and create wealth – like in the U.S. in the 1930s, the early 1970s, 1999-2002 and 2008, and other worldwide events, like emerging Asia, emerging Europe, renewable energy trends and the technology revolution. Such periods have led to asset class booms and busts in real estate, oil, metals,

*continued on page 2*

**BEST PRACTICES ... continued from page 1**

currencies, bonds, interest rates, etc. The wild swings in prices, leading to opportunities as well as risks, are proof that passivity is a guaranteed way to lose, at worst, and have inferior results, at best.

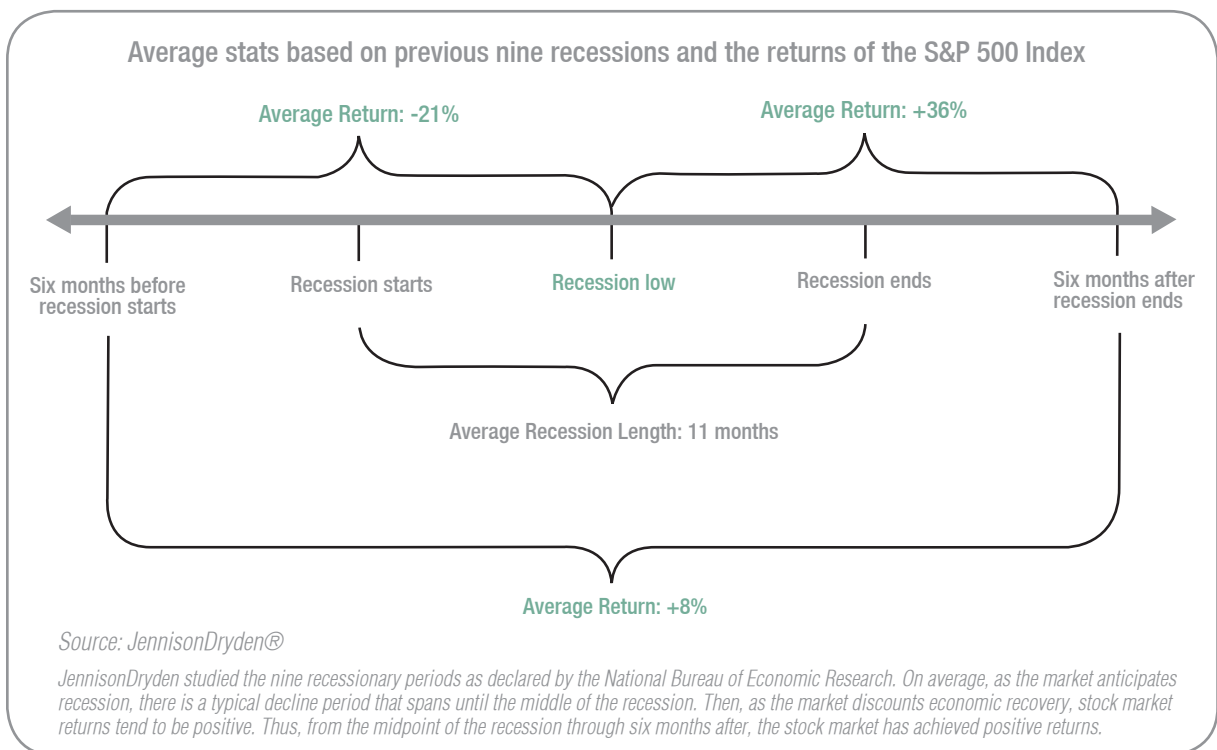
**Volatility Is Reality**

Winter turns into spring, and spring turns into summer. Recessions lay the seeds of recovery. Booms will go bust, and busts will become booms. No one can “time” the markets, and successful long-term investing has one constant side effect: volatility. Understanding that volatility exists and is part of the successful investing landscape actually helps long-term performance; however, volatility can be uncomfortable, especially during manias resulting in market peaks and bottoms. A best-practice system sees opportunity in busts, bear markets, panics and other investor psychological extremes to apply careful security analysis, a price matters discipline and

other sustainability and values-driven tools (e.g., patience, forward-looking analysis) to achieve favorable long-term investment returns. This approach will cause investors to invest “too early,” as no one can time a market’s recovery perfectly. As Warren Buffett said, “The Stock Market is designed to transfer money from the Active to the Patient.”

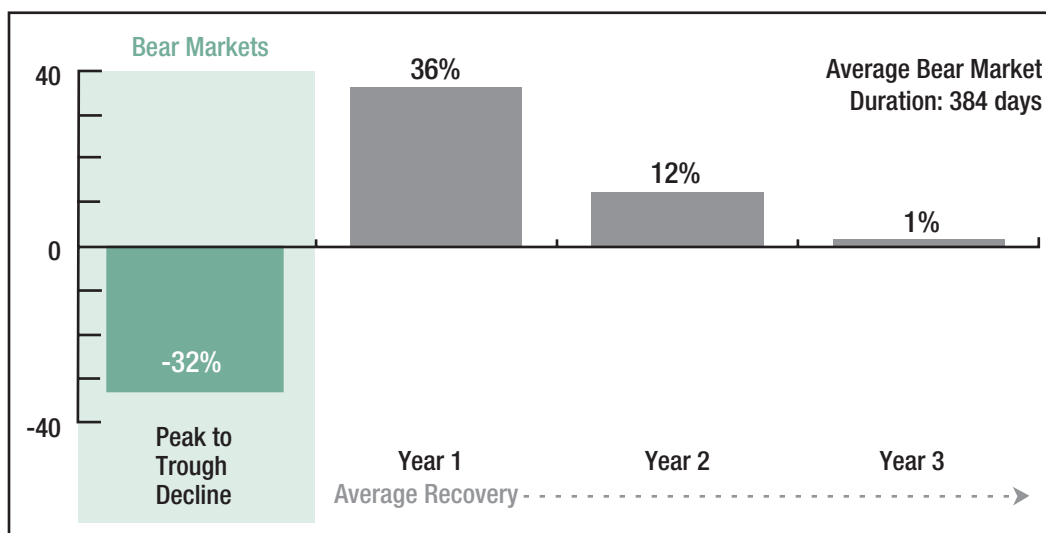
**Risk Management**

Attempting to time a market is a risky and wasted effort. When a market, asset class or investment is priced to imply a high expected return, it should be considered. Any historical market analysis concludes that it is better to be early than late. The S&P is the one asset index that has the most data available to test investment history. Using this resource, Jennison-Dryden, a division of Prudential, researched this “be early” sustainability idea. Their results are illustrated below:



BEST PRACTICES ... continued from page 2

Average returns based on previous nine bear markets and the returns of the S&P 500 Index



The S&P 500 Index is a weighted, unmanaged index composed of 500 large-cap stocks. It provides a broad indicator of stock price movements. Investors cannot invest directly in an index.

Source: JennisonDryden®

JennisonDryden studied the past nine bear markets. On average, the market declines substantially as the economy contracts. Then, as the market discounts economic recovery, stock market returns have historically been quite substantial in the following year, followed by lesser returns in the following two years. Thus it's important to be in the market and experience those returns when the market rebounds.

More volatile markets tend to come out of bear markets with returns substantially in excess of those of the S&P 500. For example, the S&P Asia 50 index, which measures the four major markets in Asia, had returns from its bear market bottom on September 4, 1998, through September 3, 1999, of 123% in its first year of recovery. Missing the bottom and waiting three months to have invested in this index reduced the 12-month return by 43 percentage points to 80% for the period of December 4, 1998, to December 3, 1999.

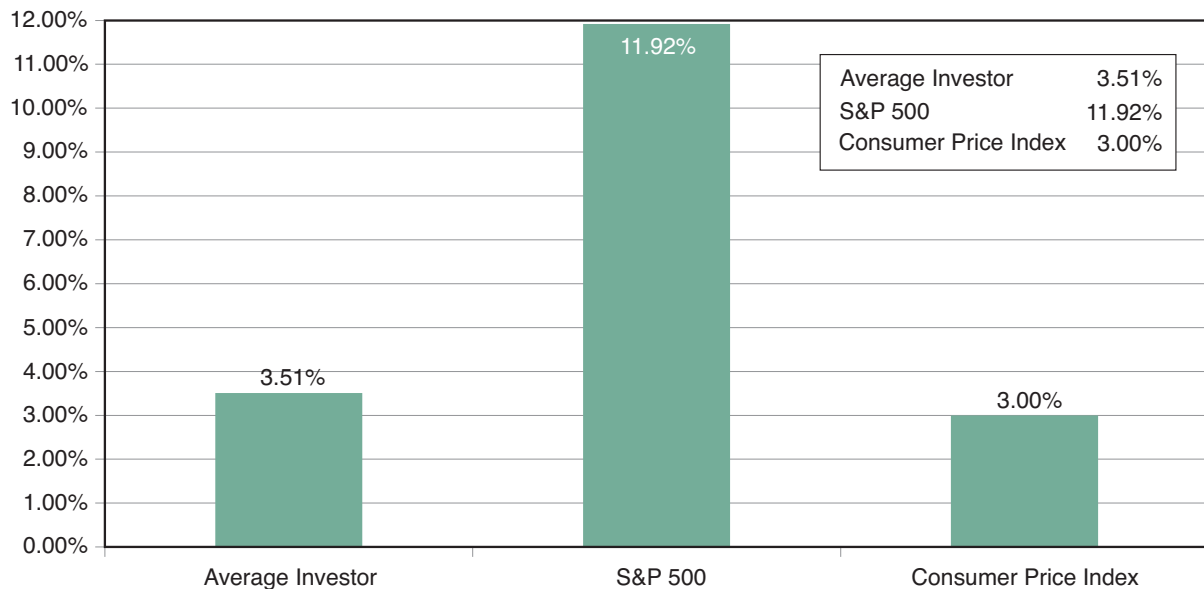
**Risk Management II**

Risk management is embedded in best practices. It is not about volatility management alone, but rather about objectively looking at

investments as tools. Portfolio management is about achieving goals, minimizing risks and maximizing potential. It is not about panic selling, going to cash or CDs when there is volatility, or trying to time the market. I have yet to find any research, book or study that champions CDs, money market investments or fixed annuities as anything other than meeting short-term needs for cash. Nor can I find any credible evidence of a strategy emphasizing 100% cash or CDs as a portfolio strategy. Yet statistics show that today's investors – despite the fact that the best valuations and the greatest opportunities in a generation are available – have more money allocated to CDs and cash than ever before in history. Again, the irrationality of investors' behavior is driven by the four poisons.

BEST PRACTICES ... continued from page 3

Annualized Returns from 1985-2004



Sources: Dalbar, Bloomberg, Standard and Poor's

**Summary**

2009 marks my 25th year of managing portfolios. 2008 was for sure our most challenging and disappointing year. We were obviously early, but I believe our disciplined approach is rational, appropriate and based on proven time-tested best practices. We have a history of success despite having basically matched the markets last year. However, we have not set aside our disciplines or thrown out history. Based on the irrational level of prices of the securities, I

believe 2009 has the potential to be our best year ever. In year-end letters to clients, I have often chatted about “another good year.” I believe that 2008 will be looked back upon as laying the groundwork for many subsequent incredible years. I sincerely believe that future year-end letters will again end and begin with “another good year,” and quite possibly next year’s will begin with, “2009 was an incredible year.” **F**



*On a personal note: Paul's wife Amy left January 11th for Zambia to adopt a 7-month old baby boy. Zambia law requires a 3-month in-country foster period before releasing a child into an adoptive family. Paul expects to visit Amy and their new baby the second week of February.*

## Investment Team Briefs (January 5, 2009)



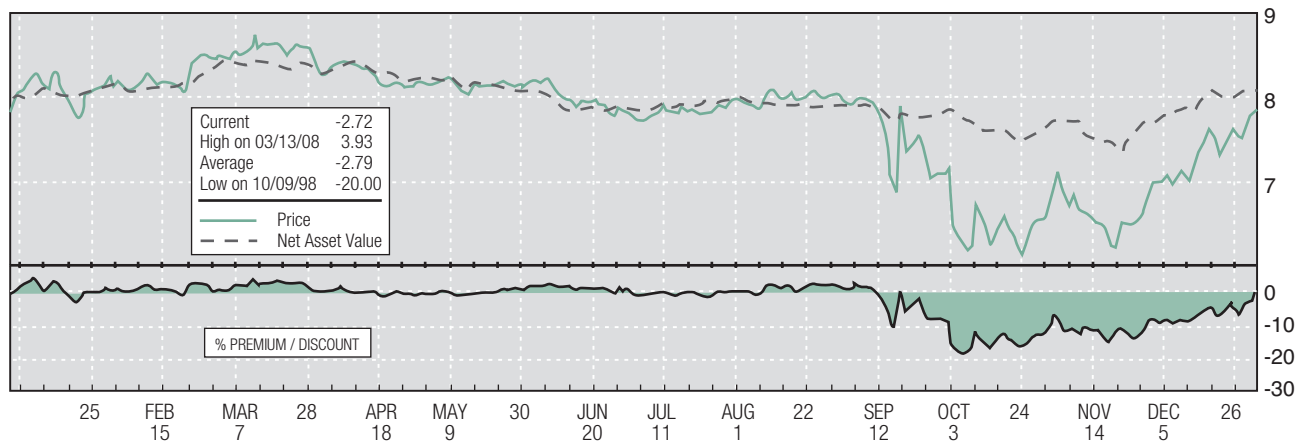
by Zach Liggett, CFA

**Item:** Closed-end fund discounts are beginning to narrow, bringing prices closer to net asset values.

**FIM Group Response:** One of the primary investment areas our team has focused on over the years is closed-end funds (CEFs). CEFs are typically exchange-listed, professionally managed companies that invest in stocks, bonds and other marketable securities. Unlike their more popular open-end mutual fund counterparts, CEFs have a fixed number of shares and do not issue or redeem shares to meet investor demand. Instead, the market price of CEF shares fluctuates as supply and demand changes in the marketplace. This characteristic creates unique opportuni-

ties for us to buy CEF shares at significant discounts to net asset value (NAV). NAV is simply the market value of the CEF's portfolio securities plus all other assets less liabilities and divided by the total number of shares outstanding. At times such as now when fear in the market is high, CEF's discounts widen and present a "triple crown" return opportunity from 1) the dividends and interest earned and distributed from the underlying holdings, 2) appreciation in the market value of the underlying holdings; and 3) a narrowing in the discount between the market price of the CEF and its NAV. FIM Group portfolio holding Templeton Global Income Fund (GIM) exemplifies the opportunities we have been seizing in CEFs. GIM is a CEF that specializes in global bonds. As shown in the chart below, GIM traded at or above its NAV through most of 2008 until Fall when market sentiment in many bond markets deteriorated. As shown in the divergence between the solid line (price) and dashed line (NAV), the discount to NAV (lower shaded area) ballooned. We started buying aggressively for some of our strategies in October at double digit discounts (e.g., we paid 80 to 85 cents for \$1 of net assets), and we expect to benefit from the "triple crown" noted above.

Templeton Global Income Fund



Source: Bloomberg

## Tax Update

In late December 2008, President Bush signed legislation that included provisions to help older Americans with some much-needed financial flexibility as they struggle to manage their finances during this difficult economic

time. A key provision in the recently passed *Worker, Retiree and Employer Recovery Act of 2008* is designed to help alleviate the financial burden facing seniors who have seen their retirement savings shrink dramatically. The new provision provides relief to seniors by allowing them to keep money in retirement accounts that they are typically required by law to withdraw

*continued on page 6*

## TAX UPDATE ... continued from page 5

upon once they reach age 70 1/2. Here's a brief summary of this new provision:

As you know, the tax law requires individuals with retirement accounts to make withdrawals based on the size of their account and their age every year after they reach age 70 1/2. This rule is intended to prevent wealthy individuals from using retirement accounts as a tax shelter. Any individual who fails to take a required minimum distribution (RMD) is heavily penalized by the IRS, which taxes the amount not withdrawn at 50%.

The new law suspends the required minimum distribution from retirement accounts in 2009. This waiver, which is available to everyone

regardless of their total retirement account balances, applies to all defined-contribution plans, including 401(k), 403(b), 457(b) and IRA accounts. The law also waives 2009 RMDs for beneficiaries of inherited IRAs.

Suspending the mandatory withdrawal allows retirees to keep the money in their account if they choose, and potentially recover some of their losses.

Since the RMDs are not required for 2009, if you wish to make any changes to your monthly IRA distribution schedules for this year, please contact our Client Services department at 1.800.632.5528 and they can assist you with any changes.

### Quote

"The most common cause of low prices is pessimism – sometimes pervasive, sometimes specific to a company or industry. We want to do business in such an environment, not because we like pessimism but because we like the prices it produces. It's optimism that is the enemy of the rational buyer.

– Warren Buffett, 1990

### The Quiz

In addition to the Treasurer of the United States, who else has his or her signature appearing on U.S. currency?

- A. The president
- B. The chairman of the Federal Reserve Board
- C. The Secretary of State
- D. The Secretary of the Treasury

Answer online at [fimquiz.com](http://fimquiz.com) to be eligible for a monthly prize.

### Disclosure

Performance data quoted represents past performance. Past performance does not guarantee future results. All performance assumes reinvestment of dividends and capital gains. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. Performance data current to the most recent month-end may be obtained by calling 231.929.4500.

Founded in 1984, Financial & Investment Management Group provides global investment management solutions to individuals, corporations and advisers. Our dedicated and talented team of 33 professionals works from offices in Traverse City, MI, Onalaska, WI and Maui, HI. FIM Group actively manages more than \$350 million in client assets.

PUBLISHER – Financial & Investment Management Group, Ltd. (Hereinafter referred to as FIM Group). *Current Observations* is published 12 times per year, 111 Cass St., Traverse City, MI 49684; Telephone: 231.929.4500; Fax: 231.995.7999; E-mail: [info@fim.net](mailto:info@fim.net); Web page: [www.fim.net](http://www.fim.net). This and all editions of *Current Observations* is reviewed by the FIM Group Investment Policy Committee. All information presented herein has been compiled from sources believed to be reliable. However, no representation or guarantee is made as to the accuracy or completeness of information obtained from third parties. Readers are further advised that successful investing is more art than science and, therefore, no strategy, chart, graph, theory, philosophy, method, system or formula discussed in this newsletter can guarantee favorable results. FIM Group, its officers, directors, employees and members of their families (hereinafter referred to as "associated persons") may have established positions in securities that are recommended for purchase by FIM Group in this publication. FIM Group believes in following its own advice and encourages its associated persons to invest in accordance with the advice provided to its clients and/or subscribers. FIM Group client account transactions are given priority over those of its associated persons. Unless otherwise stated, all opinions in this newsletter are those of the individual FIM Group Representative preparing the article and are expressed with the understanding that: (1) the opinions are not based upon the individual needs or investment objectives of any individual reader or group of readers; (2) readers will seek independent investment advice from their adviser before making any investment decision; and (3) any favorable comment or recommendation made in this or future issues is not a representation or guarantee that following the recommendation will result in a profit or reduced loss. All rights reserved. Permission to reprint any material herein is granted provided full credit (including address) is given to FIM Group. In addition to publishing this newsletter, FIM Group provides investment counsel, portfolio management and financial planning services to its clients. Subscriptions to *Current Observations* are provided without cost to FIM Group's clients.

As per SEC Regulations, this is to inform all interested parties that Financial & Investment Management Group, Ltd.'s FORM ADV PART II is available upon request by writing FIM Group at: 111 Cass St., Traverse City, MI 49684.