

September 2002

Which Roller Coaster Do You Want To Ride?

Several times in recent months, acquaintances have inquired about our health, business and general condition, given recent market volatility. Wall Street follows a convention of using “volatility” as a euphemism for “horrendous market decline.” When the market was volatile but screaming upward in the late 1990’s, you heard little talk about “volatility.” The assumption of our questioners seemed to be that we have been through a very harrowing time. Whether these questions reflected legitimate concern or the curiosity that slows people down to gawk at a wreck on the highway, we were nonplussed. Sure, the market has declined, but things have seemed fairly quiet here.

Nobody spoke about “volatility” when the market was volatile but going up in the late 1990’s.

We became less confused in the course of preparing materials before meeting with a client, a corporation for which we are managing a defined benefit pension account. We were comparing the account’s performance relative to various indexes since we took over its management in early 1999, which resulted in the preparation of the chart on the back page.

One of our rules for this newsletter is that we never talk about performance, particular investments or Sigma’s prowess (or lack thereof) in picking investments, and we do not intend to break that rule here. The chart is an apples to oranges comparison, since our client has a balanced, diversified account including an allocation to bonds. We are not claiming that the account on the chart is representative of Sigma clients. We have accounts that are more aggressively positioned and others that are more conservatively positioned than this account. Even among our accounts with a similar asset allocation, we have had accounts that have done both better and worse. As the ads always say, past performance is not a guarantee of future results.

No, the point of the chart is the difference in the intensity of the roller coasters investors have had to ride over the past few years. Scary roller coasters can be fun for a while, but if you ride on one long enough, you start to feel nauseous. Investing success lies in overcoming human nature. You can imagine the agony of holder of the diversified portfolio, holding bonds, small stocks, foreign stocks, and value stocks, at the end of 1999 as his buddies got rich in tech stocks. When your neighbor buys a Ferrari with her stock market winnings, it is hard not to be envious. When you see the Ferrari repossessed, remember the smug feeling you have is probably the same emotion felt by your neighbor at the time of her purchase.

It’s not just small investors that fall prey to human nature. We remember a September 2000 interview with the manager of the endowment fund for Notre Dame University. The manager bragged about ridding the endowment portfolio

of “stodgy” investments like value-oriented stocks and bonds, the investments that have done well ever since. We hope he at least had fun on his ride.

Following a rational, diversified investment discipline is simple, it just isn't easy.

When your diet fails, it is not because your nutritional plan, if rigorously followed, would not help you lose weight. You fail because you did not have the discipline to

follow the diet. An investor in speculative stocks might eventually do well, but how many people can ride that roller coaster and stay the course? Human nature makes us get unreasonably excited when stocks are up (and expensive) and overly disgusted when stocks are down (and cheap). When was it easiest to throw money at speculative stocks? At the top in early 2000. When was it most difficult to accept the discipline of a rational, balanced, diversified portfolio? At the top in early 2000.

The chart does not predict the future course of the stock market. To the extent that the recent decline continues, our clients, along with all stock investors, are likely to lose money. If the manic bull market roars back, a diversified portfolio may again seem dull. We do not control the future of the financial markets, but we can control the severity of the roller coaster we choose to ride. Contact us if you would like help in avoiding nausea.

