

The Nettle and the Flower: Uncertainty and Security

In 1652, the prosperous Dutch colony of New Amsterdam, fearing attack from the British colonies in New England, built a defensive wall on the town's northern edge. The colony was not attacked until 1664. Instead of an army marching from the north, however, the British navy sailed in from the south and the Dutch surrendered. New Amsterdam was given as a birthday present to James, the Duke of York, younger brother and heir to King Charles II of England. To commemorate the gift, the town was renamed New York. As the town and its traffic grew, the space behind the wall was used as a road and named Wall Street. The wall never served its defensive purpose and was removed in 1698.

*"The only safe course... is to
expect no safety."
-- Virgil, Aeneid*

The Great Wall of China is one of the "seven wonders of the world," if people still talk of such things. Built over 2,000 years ago, it remains the only human achievement visible from space. The Wall was constructed to keep out the barbarian Huns, but the Huns understood human nature and just bribed the guards when they wanted to attack China. The French tried to construct a similar barrier after World War I in the Maginot Line. Hitler's paratroopers, blitzkrieg tactics and an end run through Belgium left the Maginot Line standing as a monument to the futility of fixed fortifications.

America was attacked on September 11 in a manner beyond the imagination of most citizens. Sigma's principals are pretty neurotic, but in the long catalog of things we worried about before September, anthrax wasn't on the list. Recent events teach us that just about anything can happen. Armies don't always march towards your prepared defenses. Greed and fear can overcome a lot of loyalties. Like the French military, the Chinese emperors and the Dutch in New Amsterdam, we have learned the hard way that security is always relative, never absolute.

It is a mistake to believe the future will be like your lifetime so far. Most investor experience now is a subset of the longest bull market in U.S. history. If we had a nickel for every time somebody told us that the real risk is to not be in the market (or tech stocks, or hedge funds, or tax shelters, or...), we would be as rich as those people thought they would become. Have you ever wondered why the new, new thing you are about to do is always sure-fire, unlike all those dumb things you have actually done?

Long before September 11, panic ruled Wall Street. In 1999 and early 2000, investors panicked into Internet and related technology stocks, since their day-trading neighbors were getting rich and they weren't. Since spring 2000, they

have watched out the window as the neighbor's Ferrari was repossessed and panicked into safer investments. Often, the "safer" investments were just whatever type of stocks that had resisted the decline previously but were about to catch up.

It's human nature to pretend things are more certain than they really are. Yes, stocks have averaged around an 11 percent total annual return over the past several decades, but someone investing a dollar for 20 years actually wound up with either \$3 or \$18, depending on which period she actually lived through. The average return sounds nice, consistent and safe, but the range of actual possible outcomes chills the heart.

The desire for an unattainable security is ultimately destructive, but financial services and products are often marketed by promising the desired certainty. Major Wall Street firms that bragged about their Internet analysts a couple years back are now putting ad supplements in *The Wall Street Journal* lauding the benefits of a balanced asset allocation (using their "products," of course), acting as if it was always their advice. Investment icons appear in reassuring TV ads, pretending that they always told us bear markets are inevitable. Gurus of investing, who not that long ago were advising investors to go for the gusto with growth and technology stocks, are now recommending separate accounts, venture capital, hedge funds or other exotic (and, ideally, mysterious but exciting) investments to divert attention from the results of their previous recommendations.

***“Out of this nettle, danger, we
pluck this flower, safety.”
Henry IV, Part 1***

If there is no absolute security in investing, how then to proceed? The correct, if somewhat boring, answer is to have a rational, consistent discipline and methodology that can be applied to a wide variety of markets, including markets different than those you have experienced recently. The 1990's gave rise to a religion in which anything other than a 100 percent equity allocation was considered apostasy. At the dawn of the big bull market in 1982, with the market down 22 percent from 1966, someone recommending a 100 percent equity allocation would have been considered quite outlandish. Since the future cannot be predicted with any certainty, a valid long-term strategy is founded upon an approach that allows you to adjust to the almost infinite number of possible outcomes.

Unchanging investment "fortifications," whether in the form of a required fixed allocation to technology stocks or a retreat into Treasury bills, are futile. Success and ultimate security in investing is a result of a process, not a magic-bullet product. If you would like to apply a consistent, rational approach to your investments, give us a call.