

The Most Important Thing

Sitting in your living room with your family, warm and jovial after a holiday meal, you are discussing your favorite hobby – amateur interior decorating. Suddenly, you hear a crash from the dining room – one of the table candles has fallen over and started a now-sizable fire! Delighted, you pull out a sample book and start showing the family possibilities for replacement wallpaper.

True, you *will* need new wallpaper because of the fire. True, reviewing wallpaper samples is more pleasant than rushing everyone outside into a wintry night. True, pursuing your hobby has more appeal than fire fighting. True, comparing colors and pattern has more charm than calling 911. Nevertheless, most of the time there are more vital issues than entertainment and short-term amusement. Yet in the investment world, many ignore crucial concerns to pursue something less important but more alluring. The investment world is full of many true and exciting things. Investing successfully is hard because the true things are not exciting and the exciting things are not true.

The typical portfolio is a jumble of investment products, a hodgepodge of once-hot industry sectors and investment styles, and a heap of hope, but not much in the way of an overall plan or a sensible structure. The most important things in investing are coherent asset class selection tied to the investor's goals, a rational method of manager or security selection, and a consistent application of effective investment principles through several market cycles; these are typically absent. Many investors commit the fallacy of focusing on entertainment rather than reality. What are the most common versions of the fallacy?

1. **Market strategists are not prophets.** Each January, market strategists inundate us with annual forecasts. The calendar dictates they have to pretend to be Madame Cleo staring into her crystal ball. Somewhere inside of us, we know nobody can really see into the future and predict events yet to occur, but it is tempting to pretend the strategists can.

2. **Remember the Nehru jacket.** Wall Street always has a new product that is all the rage. An army of salespeople trying to generate commissions and fees helps the buzz along. Hedge funds, exchange traded funds, separate accounts – hey, it has to be more successful than what you have been doing, right? Exchange traded funds (ETFs) now have a certain cachet, despite the fact that you could walk into a broker and buy an ETF with the money you have in your pocket right now. Yes, Sigma uses ETFs where appropriate, but they are hardly elite and exclusive, just currently fashionable. The most important thing is not your choice of investment vehicle.

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3. **If all your friends jumped off a cliff....** As well as peddling products, that army also serves as a cheerleader for the recently hot sector or investment style. There are always investments that are alluring because they have gone up a lot. However, this should not make them a magnet for your portfolio; something that has skyrocketed is probably not much of a value. Many hot sectors and styles go the way of Comet Kahoutek – lots of sizzle, ultimately a big fizzle. Investing successfully is not a popularity contest; the most important thing is not following the crowd to invest in what is trendy.

4. **Why are you so smart?** Investors seem habitually overconfident of their knowledge, forgetting others are also seeking knowledge and acting upon it. Please print out this question: “Why isn’t this information already reflected in the market price?” Tape it over wherever you reflect on your investments. Reflect how context affects how we process information. Coming from your Uncle Harry over a beer, the observation “Apple is selling a lot of iPods” seems banal and mundane. Coming from an analyst on CNBC, it is treated as wise and worthy of breathless respect.

We enclose our annual listing of the performance of the four major asset classes: large stocks, small stocks, foreign stocks and bonds. The best performer for each of the past 41 years has a box around it. On the right are two mixes of the assets, representing aggressive and balanced diversified portfolios. The data shown are from indexes, with no assumed effect from timing or security selection. Investing in the balanced mix (60 percent in stocks and 40 percent in bonds) has had an average annual total return very similar to the S&P 500 index, while experiencing substantially less risk. While international stocks have been the winners for the past three years, we believe our chart shows that when you discern a trend, it may be about to disappear. Everyone else can see what has been doing well, too.

We stifled the urge to title this newsletter *Ten Terrific Tips for Your New 2007 Portfolio; Where You Should Be Investing Now*. It might be more entertaining, but also more distant from the vital, if less amusing, reality. The common factor among most forms of entertainment is that they cost money. The most important thing in this newsletter is that we can give you the answer to where you should be investing now – with Sigma. Call us at 503-419-3938 or check us on the web at www.sigmainvestment.com.