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What's an Honest Investment Advisor to do?

Things may seem absurd in today's markets. Stocks that the market loves one day, it hates the next. Companies, which were dreams to own only a few months ago, are now laughed at as silly and worthless. Major frauds are appearing, as though corporate executives as a group have decided to cook the books to take advantage of their stock options and bonus deals. It's incredible.

But it's not unheard of, nor is it the first time it's happened. In fact it's business as usual, just at a faster pace.

Several players in the Internet business, which was eschewed only months ago, are trading at 1200 times earnings. Let me explain that figure. Suppose you took a company called BoHoo (fictional) which has a total market value of $10 billion. Suppose also that this fictional company was making a net profit of $8 million per year. This means the total value on the stock market for this company is 1200 times its earnings. Is that high?

Let's put it in perspective. If it were the year 800 A.D. and this company existed and was making its current earnings and traded at that price, you would have to wait 2 more years from today in late 1998, before it earned back its market value. You would have to have held the stock for 1200 years, about 20 generations for it to earn its market value back.

To say that 1200 times earnings is high is like saying that the universe is "oversized".

As you may have guessed, our fictional company BoHoo is not that fictional, it's based upon the real company, "Yahoo," which actually trades near those numbers.

But perhaps this is just an aberration, a single company, and a single industry, which is trading at those levels. Nope.

The Standard and Poors 500, which is an index of basically the largest 500 companies in America, is trading at 28 times earnings. The normal earning ratios that fundamental investors like for cheap stocks are about 10 but can be stretched to 15. At 28, the average is about twice as high as it should be. This means that investors, should they be experienced in the investment practices of old, expect the earnings of these 500 stocks to grow twice as fast as normal? Not!

But wait a minute, as they say on CNBC, "Things are different this time!"

I sure hope things are different now, because the last time things got this crazy the people who played the game unwisely got really hurt. For the few of you, that like me were alive back in the 60's and 70's, will remember this story. A hot technology stock (part of the "Nifty Fifty") was thought to have technology all figured out. The stock was the old Radio Corporation of America (RCA). It went from a price of about 8 all the way up to

160. At the 160 people where saying you couldn't loose. Sound familiar? (I think of Yahoo, Pfizer, Dell, Gateway etc.). When the market backed off in the correction of 1973 and 1974, guess where this high flyer went? You might remember. All the way back to 8. Ouch!

That was a whopper of a beating for those poor souls that paid $160 for it.

<u>Things aren't different this time.</u> They are identical to how they always have been. The market is like a siren out of Homer's *Iliad*. The market seduces sailors and convinces them to jump off their safe and sound ships into the water. In this case the "water" we speak of is paying absurd prices for certain stocks. In the *Iliad,* they are never heard from again.

<u>Things aren't different this time</u>. Like watching someone win at a slot machine, it looks like the player is the winner and the owners of the slot machine are the fools who are giving away their money. That playing the game is better than owning the casino. In the heat of the action when the coins are rolling and the lights are flashing and <u>the</u> <u>game</u> is making people rich it looks foolish to own the casino. But it isn't.

Time for an old "Wall Street" story:

> An executive for a major brokerage firm goes to Las Vegas for a meeting. He happens to stop by the roulette table and places a bet on the black. He wins. Happy about that he does it again, this time on black once again. Again he wins. Excited now, he places yet another wager on black, and once again he comes up the winner. Being from "Wall Street," he immediately rushes to the phone to sell his superiors on the concept of a mutual fund. <u>A mutual fund that only bets on the "black".</u> You may think it crazy perhaps but think of the sales story:
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> 1) Experienced manager;
> 2) A fantastic track record (this investment has a history with our executive of growing money at 800% for a very short time. (3 wins at 100% on roulette, compounded);
> 3) The bets will only be placed at the best Casino's.
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> The sad moral to the story is that some people would buy it. I think some of them are buying a similar line of reasoning now.

<u>Things aren't different this time</u>. This market is being run by a bunch of kids. The schools that train brokers have never been busier. This reminds me of the same thing that was going on in the late 1960's. Everybody wanted to be a stockbroker. A couple of years later the New York Stock Exchange had to loosen its rules and allow its brokers to hold more than one job so that many of them could drive taxi cabs. It's true.

<u>Things aren't different this time</u>. It's true that a lot more people are investing than ever before and that's good. It's not making things different just more <u>exaggerated</u>. The *Baby*

Boom isn't called a boom because it's small; it's called a boom because it's really big. It's the same old game just with more players. One important point many of these players:

1) Have never really played this game before and don't really know the rules, what they know is that you buy mutual funds and they're supposed to go up;

2) As newcomers, they are not even talking to people who have been in the business for more than a few years. They have no perspective and no one to talk to that does have perspective;

3) Are very greedy…

I recently had a doctor call me up for advice. The help he needed was very technical and demanded a certain amount of skill and experience. We started discussing the stock market and he told me that although he had been working over 70 hours per week in residency and internship and was just opening his practice, that he could probably pick a mutual fund better than I. The truth is, he may be right. At least in the short run because he may very well pick that "bet on the black fund" we discussed earlier.

He hasn't experienced the pain that experience teaches, and that wise people pay attention to. Personally, I wish him well, but know in my heart that he has just completed the very expensive course of study of medicine and now of his own volition, has embarked onto a much more expensive journey. This time however, without a mentor, professor, coach, or guide. To me this is the fate of many. I have to believe in the long run, it's a big, and possibly tragic, mistake because:

1) The waste of his capital as his "RCA" goes from 160 to 8 will poison him for a long time from investing in the stock market.

2) When he crashes and burns, he will stop investing and start spending the money. This is the true tragedy. I can hear him tell his wife, "It's better we spend this money than lose it in mutual funds." And so they will, and develop habits which consume vast amounts of "retirement quality" wealth.

Investing is not easy. It's like running a business. Lots of difficult decisions have to be made and frankly the more impersonal they are made, the better for the business. As the great Michael Gerber puts it (loosely quoted): <u>Business without a strategy will painfully grind your life into dust</u>.

So please forgive the interruption into your life with my thoughts. I feel it's important to state my case for value and sanity. Yes we want to own stock and mutual funds, but I chose not to own much of those that "bet on the black" or in Yahoo.

Furthermore, I want to pledge to you that I am keeping a watchful eye, that I am seeing what those "other" stocks are doing, and that I re-examine all of this on a daily basis.

All I can see so far is that a certain sector of the U.S. stock market has been the highest yielding for 3 of the past 4 years. This is unprecedented. I believe a thoughtful and wise man would be cautious about betting new money that it will continue for another such period.

We are keeping our positions in these stocks that have far outstretched reality.

We are investing new money in more realistically priced issues.

We are trying to keep our portfolios balanced. (Please don't say allocated)

We are trying to keep our clients in the 'game' for the long haul because that's where the money is. This short-term stuff belongs to the government and the brokers (via taxes and commissions) and they know it.

If the markets did not do this they could not return what they do for the patient value investor. Without this absurdity no one would sell us the stocks we need to make good money in the long run. I believe, and my experience shows, that the methodology we are using, although it may underperform at certain times, it is much more like owning the casino than playing the slots.

When it's all said and done I want to wake up knowing that I, and hence my family and clients, have won this investing game, using simple and logical skills, as opposed to waking up with a hangover and an overdrawn line of credit from some casino named "Wall Street."

One last point:

<u>Things aren't different this time.</u> True success in the markets always come, not so much from investment performance, than from investor behavior. Not from how much your funds go up but what you do with them when they do <u>and</u> when they have a temporary decline.

Case in point the Magellan fund: Peter Lynch, the famous manger that created most of the track record for the fund, stated that while he was making 19% a year at the fund, the average investors got only about 11%. This was not because of fees, expenses, or taxes it was because of the emotions of the investor. They needed to buy the fund at the top (or put more money in) and sell it at the bottom. Very classic. This is one big reason you have me, (like it or not.). My job is to keep you from buying at the top and selling at the bottom. If I can help with that just a little, I am worth my salt.

Peter Lynch summed it up this way, when asked how to make money in stocks, he said, "The answer as simple, don't get scared out of them." Now with all I have said, do you think he meant only when they have a temporary decline? Is it possible he meant that getting scared out of them means also when they are trading at high levels? When I see him I will ask him.

Meanwhile, I wanted to let you know where we stand and what we think is going on. These are exciting times and the opportunities are presenting themselves. throughout this volatility.

Please always share with me your thoughts, concerns, fears, and worries. It's a big part of my job and the service I offer you.

Kindly,

Charles S Stoll CPA, CFP, PFS