



***“Good judgment comes from experience, and a lot of that comes from bad judgment.” -- Will Rogers***

April 5, 2010

Dear Valued Client:

One of the most important traits we like to see in the investment managers we select are those that are humble enough to admit their mistakes and utilize their experiences in ways that refine and improve their investment skills. Ironically, if you read the annual letters of Warren Buffett, you will notice a common theme in that he typically always highlights his errors in judgment more than he does his successes. His stellar investment track record is in large part due to his perpetual pursuit of learning that utilizes his experiences in ways that improve on his already exemplary judgment. It would make our lives a lot easier if there was a simple “formula” we could rely on all the time to get good investment results, but unfortunately, there’s not. Investing is a science and an art, which is why words like “always” and “never” should be foreign to an astute investor’s vocabulary.

In light of the above, we would like to use this month’s investment letter to review some of the lessons we learned or re-learned from the financial crisis, given the fact that it’s been over a year since the S&P 500 hit its lows on March 9, 2009. We are relieved and even a little surprised the S&P 500 has rebounded roughly 74% from its low, but it would be a mistake to bask in recent success without gaining perspective on lessons/principles that were learned through the financial crisis of 2008.

1. When investors are gripped with uncertainty, emotions tend to rule over rational thinking.
2. As uncertainty grows into fear, security prices bear a diminishing relationship to fundamental value.
3. Market volatility is a byproduct of an imperfect group of investors who do not have conviction in what they are doing. Market efficiency and rapid/volatile movements in security prices do not go together.
4. When a large institution fails and leverage is forced to be unwound rapidly, the ripple effects are detrimental to the entire economy.
5. Valuation driven diversification among asset classes is a prudent investment strategy, but when de-leveraging is occurring simultaneously on a massive scale, correlations between asset classes will increase and the value of diversification will appear diminished during that moment in time.
6. Risk is not the same as uncertainty. Risk is not the same as volatility. Risk is the permanent loss of capital. Volatility is merely a temporary impairment of capital.



7. In a deflationary economic environment, estimating the fair value of a business becomes more challenging, which means investors should allow for a larger cushion or “margin of safety” to compensate them sufficiently for such uncertainty. \$1 of business value today could be .90 cents a year from now in a deflationary environment. However, when investors are uniformly in the mode of extrapolating deflation far into the future, chances are favorable that an investor will find some incredible buying opportunities.
8. Investment yield should never be examined exclusively without an accompanying assessment of risk being assumed. The higher the investment yield is, the more skeptical an investor should be of its capacity to generate return, net of principal fluctuations.
9. Short-term liquidity needs should not be invested in areas where principal risk is even a remote possibility.
10. Illiquidity is costly, particularly during periods where opportunity costs are high. Monetizing illiquid assets during a financial crisis is typically good for the buyer and bad for the seller.
11. An investor should view analyst opinions with a grain of salt, as their models can be easily manipulated to fit the opinion the analyst ultimately desires.
12. Beware of the following words: Financial Innovation.
13. The world is uncertain. Our future will continue to be filled with events that are out of the ordinary. There is no mathematical model that can quantify such things.
14. Investors, corporate executives, and risk managers have a short-term memory. Greed and fear are not bound by time, place, or circumstance. Institutional “groupthink” will continue to influence decision makers, as some prefer to fail conventionally than to succeed unconventionally.

We hope this list was insightful. As always, we thank you for your support and look forward working together as we move to TD Ameritrade.



*The S&P 500 consists of 500 stocks chosen for market size, liquidity and industry group representation. Each stocks weight in the index is proportionate to its market value. The S&P 500 is one of the most widely used benchmarks of US equity performance.*

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*Diversification can be thought of as spreading your investment dollars into various asset classes to add balance to your portfolio. Although it doesn't guarantee a profit, it may be able to reduce the volatility of your portfolio.*