



Second Quarter 2008 Performance Report

What happened last quarter can be summed up in two words: OIL PRICES. The first quarter was all about SUBPRIME but as the second quarter began, that problem seemed to be containable as the Fed made it clear it was willing to support the market and there were few signs of the financial contagion spreading beyond the banks and brokers. The market moved higher as there was a collective sigh of relief when it appeared we had avoided a financial meltdown. Then came \$140 a barrel oil, a shock to the economy which the government couldn't paper over and couldn't be contained in one sector. That blow put us right back to the March lows in the stock market and then some. We sank to twenty percent off the October market highs, enough to officially qualify as a bear market.

If the gloom on Wall St. wasn't bad enough, the mood on Main St. was even worse. We've had six straight months of job losses; food, health care and energy prices are killing the consumer; housing prices keep sinking; the war rages on and the presidential candidates seem to have fewer solutions the closer they get to trying to answer the questions.

But, the jobless rate is only 5.5%, not that far from full employment; the consumer is still spending according to the latest retail sales figures; inflation won't spread to the rest of economy as long as wages don't rise and workers who are worrying about their jobs don't ask for raises; lower housing prices are translating into cheaper rents and entry level homes for the people who need them the most; whatever the next president does, he couldn't make a bigger mess of things than we've already made.

Oil is being buoyed by an increase in demand from emerging economies, a dearth of new supply, a lack of alternatives, a weak dollar, and a speculative frenzy. Of course at some point, this should all reverse. Emerging economies should stop subsidizing the price increases (China finally raised oil prices 20% a few weeks ago), prices should increase supply (we're drilling in places we never thought we could), alternatives to fossil fuels should come to market (we're putting hundreds of billions into research), most importantly, we hopefully will have stopped wasting so much energy (there is finally a change in consumer behavior that everybody thought would start at \$50, \$75 and \$100 a barrel), the dollar has been stable to gaining against most currencies lately (when Europe finally realizes that it's in a recession, the euro will likely fall against the dollar too), then speculators will likely drive oil prices down (they don't care which way the commodity moves, they just want it to move fast).

If the Middle East blows up, the break in oil prices could come from \$200 dollars a barrel instead of \$150, but it will come. After that, we can only hope that oil stabilizes at plus or minus \$100 a barrel because that seems to be the price that historically the good things about high oil prices have kicked in. At \$100 we begin to conserve, alternatives become cost effective and exploration is rapid. The long term benefits to the developed world's economies of not sending five or six percent of their GDPs to producing nations in the form of energy imports is tremendous. Think of what will happen when we replace some of the 700 billions of dollars a year we spend on imported oil on solar cells, wind turbines and domestic geothermal projects. A dollar sent to Saudi Arabia has almost no multiplier effect on our economy. A dollar spent on a GE wind turbine creates jobs, wealth and tax revenue for the US.

As the third quarter began, investors questioned the viability of Freddie Mac and Fannie May, they crushed the regional banks involved in construction loans and the market continued its assault on the big banks and brokers. The financial sector, once the model of innovation and consistent growth is now the poster child of stupidity and irresponsibility. Of course the truth is somewhere in the middle and there will be both winners and losers in the current financial crises as we clean out the excesses of the housing and credit bubble. The losers will be liquidated but the winners will get the liquidated assets at a fraction of what they will be worth a few years from now. If history is any guide, the surviving financial institutions, which will be the vast majority, will emerge stronger than they have ever been. Fortunes will be made as confidence eventually returns to the sector and beaten down stocks prices begin to reflect the true value of their franchises.

Long-term it's easy to be bullish about the economy's potential growth when energy replacement begins to vitalize our economy and we clean up the bad loans, but what about now? Shouldn't we find a rock to hide under until oil prices crack and the world is a safer place? Or, lacking a rock, how about selling stocks and going to cash or bonds (which don't pay much more than cash but at least look like you're still an investor). After all, it's now a bear market, we're losing money and we need to do something!

The only problem is...how are we going to make money on a long-term basis if we sell stocks after they have gone down? When do we buy them back? After they have gone up? It turns out that that strategy will not just hurt your investment returns, it has the real probability of turning long-term positive market returns into negative ones. Clearly, this is not a good investment policy, even if it feels good.

We think our investment policy makes more sense. We fully expect to market corrections because they happen every four or five years on average and are unavoidable. When corrections occur we take any tax losses we can, we reallocate bonds and cash to stocks so that our accounts return to a predetermined balance, we sell portions of highly appreciated stocks (energy and natural resources are up) and buy bargains (cyclical and financial stocks are on sale).

If it's a little correction we'll do a little of that. If it's a big one, we'll have a lot of work to do. If the correction continues, we'll do it again. There may come a day when the market is so expensive, when the fundamental case for the US economy is so bleak or the world economy is so hostile that US equities should not be purchased. That would be a case similar to Japan in the late eighties before they enter a decade long recession, crushing deflation and political paralysis. Had we been managing Japanese equities, we hope we would have been smart enough to leave the market. But we don't think that is anything like the case for US equities now and so the best course is manage portfolios for profits, not change what has been a highly successful investment policy that we have followed for decades.

That's what we said we would do twenty five years ago when we started in this business. It's what we've done in every market correction we've lived through since then and it's what we are doing now. Before long we will look back on this correction the same way we looked back on the tech wreck in 2001 and 2002. We will wonder how stocks ever got so cheap and why everybody didn't see the great buying opportunity a little panic gave long-term investors.

INVESTMENT POLICY

“After you read this book you will know all you need to know to be truly successful with investments.”

So begins Charles Ellis' 1985 book, *INVESTMENT POLICY: How to Win the Loser's Game*. If this claim wasn't remarkable enough, Mr. Ellis attempts this feat in just eighty-five pages. I believe this book largely meets its immodest goal, as witnessed by the fact that of the dozens of volumes I have on the subject, this text is the one I have turned to most often when trying to explain market realities and my investment philosophy.

Ellis was well prepared to write on the subject. He was managing partner in the financial consulting firm *Greenwich Associates*, chaired AIMR (an international investment management association) taught at Harvard Business School and Yale School of Management. Clearly, Ellis could have written a much larger and more complicated book but its beauty is in its simplicity. Unfortunately, the original edition has been out of print for many years. You'll have to settle for the 2002 edition, which is twice as big but titled simply, **How to Win the Loser's Game**.

Why is investing a “loser's game?” Don't stocks and bonds have long term positive returns that make investing a net winner's game? Yes, but Ellis makes several points in describing current investment practices as a “loser's game.” The first is that, as many studies have shown, investor's obsession with chasing short-term performance by excessive trading and other forms of speculation has resulted in the average investor losing money, even in bull markets.

Secondly, institutional investors who become obsessed with beating the market play the same loser's game as individual investors. They take undue risk with their client's assets on the misguided belief that they can predict the direction of the market. They try to concentrate portfolios in winning sectors or select stocks that will outperform the averages when they should be concentrating their attention on creating well diversified portfolios for their clients.

“Unhappily, the basic assumption that most institutional investors can outperform the market is not true. The institutions are the market. They cannot as a group outperform themselves. ...Because investing institutions are so numerous and capable and determined to do well for their clients, investment management is not a winners game. It's a loser's game.”

Conceptually, investing is a loser's game because it is game where points are lost, not won. Think of tennis or golf as they are played by all but the very top players. Something like 80% of the difference between winning and losing is due to mistakes, not great shots. The best advice that any pro could give to an amateur is; **Stop Making Mistakes!** Players who fail to recognize this fact, who attempt to hit long drives to the green or winners from the baseline are an ideal opponent for players with less talent but greater prudence. Similarly, investors who attempt to beat the market, hold only winning stocks and ride the current trend are doomed to playing a loser's game.

The way to win in competitive sports is to “play your game,” “play within yourself,” “don’t let your opponent dictate your strategy.” The way to win in investing is to have a sound, well tested investment strategy and stick to it, regardless of what the market pundits are saying or what new scheme Wall Street has devised for instant profits without risk.

How can something as boring and mundane as an investment policy be the holy grail of investing? The answer is that a well developed and clearly stated investment policy forces investors to have appropriate expectations and money managers to act prudently. If that happens, they are well on their way to making money consistently.

If the average “investor” put his or her “investment policy” in writing it would read something like this.

I will overweight my portfolio in whatever is hot in the market regardless of my own or my advisor’s level of competence in managing that investment. I will require my investments to produce a higher rate of return than the market but will sell any investment when the absolute rate of return turns negative. My commitment to my investments will follow the whim of whatever I read or watch on TV, concentrating on news sources most unsuitable for long-term investors. I will track the performance of my investments daily to assure a maximum amount of short-term anxiety even though my investment time horizon is decades long. My bench mark for success will be constantly changing depending on what I hear others are doing and how I feel at the time.

Sound familiar? Of course a sound investment policy should be the exact opposite of the Jim Cramer, Mad Money policy outlined above. Managers should be selected based on their long-term returns and ability to meet your investment objectives, not what is hot today. Your objective should be to get a market rate of return taking into account the income, tax efficiency and added safety you may require. Your time horizon should be years, if not decades and your portfolio should reflect your long-term investment objectives. You should expect your manager to avoid today’s bubble, because it is the best way to avoid tomorrow’s bursting of the bubble and you should do the same in your personal investing. You should change your investment policy only when your personal circumstances change, not because of market fluctuations. That’s playing your game, not the market’s game.

BEATING THE MARKET

“There are two kinds of problems in trying to beat the market. One problem is that it is very difficult to do – and so easy, while trying to do better, to do worse. The other problem with targeting on beating the market as a primary investment objective is that its focus diverts attention of both the investment manager and the client from the need to establish long-range objectives and investment policies that are well matched to the particular needs of the individual client.”

Still, the market is the benchmark we use to measure our performance. Shouldn’t we try to beat it? We can try, but realize that most schemes to beat the market require some form of additional risk. Ellis categorizes four basic approaches professionals use to try to beat the market.

Market Timing

Of the four ways money managers can beat the market, market timing is the easiest to discredit, but the most difficult to avoid. What interview with a successful money manager doesn't start with the manager's view of the market and confident prediction of the exact market close months from now? Never mind that the future is by definition unknowable, the manager's past record is no better than a coin toss and if you ask five prominent managers where the market is going you will get five different answers. We cling to the hope that there is a wizard behind the curtain who can get us in the market for the good times and save us from market corrections.

Ellis quotes a seasoned investment professional on the question of market timing. **“I've seen lots of interesting approaches to market timing – and I've tried most of them in my 40 years of investing. They may have been great before my time but not one of them worked for me. Not one!”**

The problem with believing you can time the market is that it creates a false sense of security. The investor goes to war armed with the paper shield of market timing only to see his portfolio decimated by an unexpected market correction. Shell shocked he goes to cash just in time to miss the best part of the recovery and instead of beating the market, does much worse.

A glorious liberation occurs when one truly accepts the fact that the short-term direction of the market is totally unknowable. The investor is then able to fully concentrate on what will make the difference in his portfolio; appropriate manager selection, asset allocation, income and tax efficiency. Freed from the burden of being a poor imitation of an investment guru, the money manager is able to have an intelligent conversation with clients, discussing things he knows something about, instead of engaging in idle speculation.

Stock and Sector Selection

Surely, the thousands of stock analysts who work long hours at prestigious firms must be worth something? They must hold the key to beating the market in their Brooks Brother's suit pockets. Maybe they do, but it's not likely. For one thing, there are so many of them, they are so smart and they have such great access to information that their wonderful work is largely cancelled out by each other's success. In a perfectly efficient market, everything that is important is known by everyone so there is no way to get an advantage.

That is the academic theory of securities analysis. The real world view is that stock analysts are little more than hucksters whose job is to push stocks the firm has a vested interest in, not to uncover the truth. Under this scenario, stock analysts are worse than useless, they are detrimental to your financial health and their recommendations should be avoided like the plague. The number of buy recommendations on Enron right up to their chapter 11 filing and similar calls gives weight to the skeptics' arguments.

My view is somewhere in between these two extremes. If you are looking at a company you need to know what Wall Street is thinking before investing as a baseline to form an educated opinion. After you've read enough research reports you understand that 90% of what they say comes from the company's guidance and original thinking is pretty scarce. At best, most research reports give you little more than a handy summary of the company's presentation. At their worst, (or best if you are willing to trade against them) they give you an overly optimistic or pessimistic view of a company's prospects based on very short-term events.

Portfolio Strategy

Portfolio strategy is stock selection on a macro basis. It involves some variation of weighting a portfolio among market sectors and industry groups that are thought will perform better than the general market. For much of the nineties the place to be was in mega-cap stocks. If you didn't own GE, Merck, and Citicorp it was tough to make a dime much less keep up with the market. Then came the tech mania of the late nineties, culminating in the tech and telecom bubble at the turn of the century. That was followed by the relative outperformance of mid and small cap stocks and the explosion in energy and commodity shares. If you were able to ride all these trends from the beginning you made a fortune. If you got in late, you lost your shirt as each trend crashed.

Every major Wall Street firm has at least one portfolio strategist. They are brilliant at identifying which of today's market sectors are in favor. Unfortunately, they are lousy at giving investors the information they need to know – how long will the current trend last and what will be the next trend.

Investment Philosophy

The practice of adhering to a disciplined investment approach through market cycles is the investment tool that Ellis thinks has the greatest probability of success, at least if success is measured by a portfolio that delivers predictable returns relative to the market. Investment philosophies may vary from small-cap growth to large-cap value but if they are consistently executed, the investor will have a pretty good idea of what the risks and rewards are because they are likely to be based on past performance and common sense.

It should come as no surprise that given the earlier discussions of how to win the loser's game, the investment philosophy that holds the greatest promise is one that involves avoiding the overpriced investments most favored by the crowd and finding better value in securities that are currently out of favor.

“The important test of an investment concept or philosophy is the manager's ability to adhere to it for valid, long term reasons – even when short term results are most disagreeable and disheartening. Persistence can lead to mastery and development of distinctive competence in the particular kind of investing in which the manager specializes.”

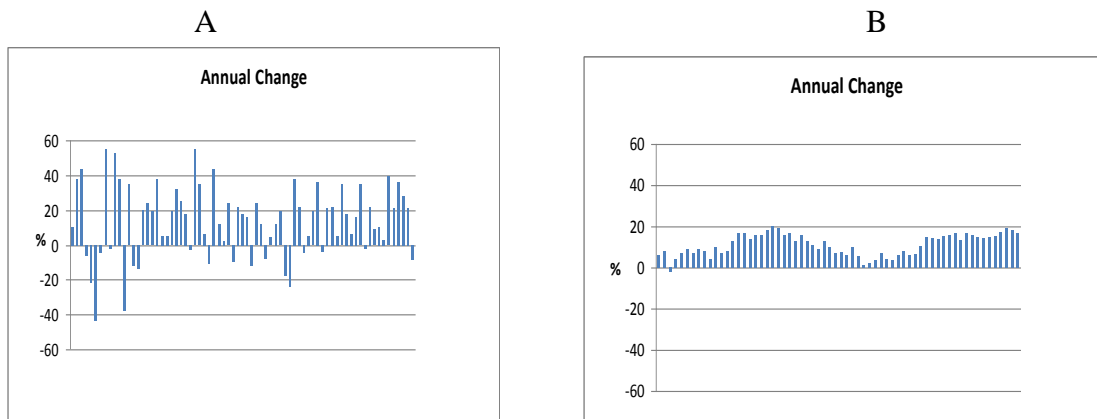
A successful investment philosophy can take many forms but it will almost always involve what Ellis calls “the power of the plodder.” The plodder welcomes market inconsistency and irrational behavior because it creates market opportunities for long-term investors. The plodder isn't swayed by the euphoria or panic of the moment. The plodder's investment philosophy remains consistent in good and bad markets.

TIME

“Time is the Archimedes’ lever of investing”

When time’s effect on investments is properly understood, time becomes the investor’s most important ally. Time compounds returns, reduces risks and favors the investor over the trader. The power of compounding is the lever that lets you move boulders when anchored with a sound investment philosophy. Investing in equities is about letting great companies grow in your portfolio for years and decades without paying a dime in taxes or transaction costs.

What if I told you that there was a way to invest that will turn the irregular annual investment returns in graph A to the nearly regular returns in graph B? Wouldn’t you use it?



Here’s the secret. Just hold stocks for ten years instead of one. Chart A is the annual returns of the stock market for each one year holding period. B is the annual returns for the stock market in ten year intervals. Simply by going from being a short-term trader to a long-term investor you have moved from a very risky investment to a highly predictable one. Best of all, you have reduced your risk without sacrificing your expected return. Chart A and B have the same average return (about 10%), they just have dramatically different risk characteristics.

So different, that on a risk/reward basis, most investors would say that a one year trade isn’t worth the risk. How many people want to trust their life savings to something that could drop 30-40% and regularly drops 20%? But the ten year chart is quite a different matter. Compared to one year returns, ten year returns are amazingly predictable, making the small risk of a subpar performance well worth the average 10% compounded annual rate of return. We know of no way to control risk without diminishing returns better than having time work for you.

Time creates the investor’s paradox which Ellis so wisely describes as the conflict between short and long-term returns. What’s good for one is almost always bad for the other. The fundamental error investors make is managing long-term investment by measuring short-term returns.

I am not exaggerating when I say that I fully expect most of the stocks I buy to underperform the market by a significant degree in the short-run. I'm looking for bargains, stocks that are beat up for one reason or another and I don't expect that sentiment to turn from hate to love just because I bought the stock. But, if I'm right, that short-term underperformance will be nothing compared to the years of superior returns I can expect when I buy a great company at a depressed price.

As Lord George Maynard Keynes said over fifty years ago: "Most [investors] are in fact largely concerned not with superior long term forecasts for the probable yield of an investment ...but with forecasting changes in the conventional *basis of evaluation* a short time ahead of the general public." That leaves the long-term investor with a clear advantage over the trader. Good long-term investments are much easier to identify than, "what the market will evaluate it at under the influence of mass psychology three months or a year hence." The prudent investor takes advantage of the market's irrational short-term behavior to find long-term bargains.

RISK

We devoted the entire last letter to that subject so I won't dwell on risk here, except to say, that an investor who just looks at returns, even a long period of consistent returns, without understanding risk, is doomed to lose money. If you have any doubt about that, just look at the institutions that are writing off hundreds of billions on mortgage-backed securities that they thought were safe or the billions lost in hedge funds with great track records.

Risk must be measured in two ways, statistically and analytically. Statistical risk is just a mathematical compilation of historic volatility. Statistics are great but to get the full picture of risk you have to do some analytics to quantify what you know (or more importantly not know) that could alter future returns. Statistically, a manager that has had a steady ten to twelve percent return for ten years looks great. But, if he did it but buying subprime mortgage pools that are leveraged twenty to one, the statistical information doesn't give you a true picture of the risk involved.

The same can be said of managers who compiled enviable records through active trading or sector concentration. If you are doing something inherently risky, the fact that you were the one in a hundred managers who made it work doesn't mean that the rules of investing have been repealed to make that fund a safe investment.

That is why we manage well diversified portfolios that are representative of the market and hold them throughout market cycles with minimal turnover. Market risk can be quantified and even mitigated by known investment strategies. Concentration, trading and market timing risks are unquantifiable risks.

RETURNS

In the 1985 edition, Ellis estimates the long term return of equities in the mid teens, bonds in the high single digits and cash near that. But then inflation had been double digits for years, the real (after inflation) returns for bonds and cash were negative and stocks had recently gone through one of the longest bear markets in history.

In the new edition he doesn't use hard numbers to estimate future returns. Instead he lays out the stock investor's creed as we know it.

1. **“Common stocks have average returns higher than do bonds or short-term instruments.”**
2. **“Daily, monthly and yearly fluctuations exceed bonds, which in turn, exceed short term money instruments.”**
3. **“The magnitude of the fluctuations decreases as the measurement period is lengthened.”**

That just says that stocks will make you more money over time than bonds or cash but you need to hold them for a while to make up for their additional risk.

How much you make on stocks in the long run will have very little to do with the things you worry about every day. It has almost nothing to do with next quarter's earnings, a few stocks blowing up, who wins the election, if the Fed cuts interest rates or even the skill of your portfolio manager, as long as he builds a well diversified portfolio and you have the guts to hold on to it.

Your long-term return will be determined by much bigger issues.

1. The future rate of inflation. Stocks will return some premium to the average rate of inflation.
2. The future rate of earnings growth, which will primarily be determined by the rate of growth in the general economy.
3. The premium or deficit over the current earnings multiple that investors will be willing to pay in the future. [Buy your stocks cheap enough and you don't have to worry about this one]. Of the three, this one will have the least effect.

Since you have no idea what any of these numbers are going to be five, ten, much less twenty years from now, you're left with the only thing we can say with any certainty. The return you will get for owning a well diversified stock portfolio will almost certainly be better than bonds and will be some multiple of what short-term money would yield.

If you want more certainty than that, we'll make up something, but we'll just be guessing.

INVESTMENT POLICY

After we dispel the myths and meet reality head on, we are left with one truth; the need for a coherent, consistent and personalized investment policy. It sounds complicated but it's just common sense.

We agree on realistic investment objectives that don't involve luck, superhuman skill or the suspension of reality.

We present a plan within our competency for the long-term achievement of those objectives with the related risks and benchmarks.

We provide you the information you need to monitor our progress in meeting your investment objectives and our performance. In the short run, we will always be exceeding or falling behind these objectives but you should be able to see the logic in how we built your portfolio and how well we applied a consistent investment philosophy. Over time, we should accomplish your objectives and you should be comfortable with your investments.

There you have it. You now know (almost) everything you need to know to be a successful investor. Now, it's just a matter of you and us, implementing it properly.

Bill Matthes

Winning the Loser's Game; Charles D. Ellis, McGraw-Hill, 2002.

"The best book on investment policy and management" Peter Drucker

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