



Year End Report 2009

2009 was a great year! It was a great year if the stock market's early dive didn't scare you to death and you rode the bull market rally despite the "experts'" advice. It worked out even better if you bought some of the financials, tech stocks or busted growth stocks that survived the market meltdown (not so well if you had the ones that failed). It was a great year for productivity, which went off the charts, as companies squeezed every penny out of costs. That and a weak dollar made it a decent year to be a US exporter, despite a weak domestic economy. Export demand and the resiliency of emerging markets made commodities and energy pop off their lows and stay strong all year.

It was a terrible year for the victims of productivity that lost their jobs, but it was also a miserable year for savers. They made almost nothing on their money. The price of seeking safety was very high as short and long government bonds had negative returns. The biggest, best quality, high dividend paying stocks didn't do nearly as well as smaller, riskier growth stocks. Most of the market timers who were trying to protect their principal, missed the best part of the stock rally, AGAIN. Following their advice, individual investors continued to do the exact wrong thing, selling stock funds and buying bond funds, ruining any chance they had to participate in the market's recovery.

Most importantly, it was the year the economy turned the corner from recession to recovery, a fact now recognized by all but the most apocalyptic economists. Still, the prevailing mood is gloomy. Sure there has been a modest recovery, but it has been artificially induced by government spending. Sure corporate profits are rising, but they aren't hiring yet. The stock market is up 30% this year, but it doesn't make up for last year's losses. The prevailing wisdom is that soon taxes, interest rates and inflation will be going through the roof and whatever was made back this year will be lost again.

If markets climb a wall of worry, this market is climbing up the Dubai tower. Pessimism is the new national religion. I really don't have much of a problem with bears. The market typically has its best returns when investor sentiment is the weakest. I just don't like seeing blind negativism being passed off as informed commentary.

If there is one word that sums up 2009, I think it is **DISALLUSIONMENT**. We elected a new president with great expectations, but found out he couldn't solve our problems overnight (if ever). Americans were supposed to pull together, but we are probably more divided than ever. We saved the banks, but they didn't save the rest of the economy. We tried to fix the health care system, but ended up with a bill that probably brings Medicare and Medicaid closer to insolvency. When the economic tide went out, we saw that some of the world's most trusted money managers were just Ponzi artists. Investors have just had one of the worst decades for investments this century and the baby boomers are about to retire with empty nest eggs. Our homes turned out to be places to live instead of ATM machines. Even our sports idols turned out to be false gods.

To be disillusioned you have to have an illusion to begin with. If you really thought the government or the banks would save us; that there were risk free double digit yielding investments; that stocks or house

prices couldn't go down and athletes were good role models...you had a bad year. For skeptics, 2009 just reaffirmed their basic beliefs.

2010 is likely to be the year that the recovery moves from the board room to Main St., which should make at least some people a little less pessimistic. With any luck, we should see small business lending pickup, unemployment peak and stabilization of home prices in most areas of the country. If that happens, there will be an uptick in interest rates, which will benefit savers and maybe force some home and car buyers to get off the fence. We can predict with absolute certainty that the pace of the recovery and direction of interest rates will cause the stock market to go up and down. We just don't know how much or when.

Because we don't know what the stock market will give us, we will continue to be fully invested while trying to favor industries and individual companies that are attractively priced. The first step in this strategy is more or less automatic. We regularly pare down the stocks and industries that are giving us outsized returns, hoping to "sell high."

In balanced portfolios, the cash we raise will go partially to bonds to keep the asset allocations in range. The rest will go to feeding the dogs. We will be buying more of the worst performing stocks and industries hoping to "buy low," just like we bought the financials and techs when nobody loved them.

Today's market doesn't offer the super bargains we saw at the beginning of last year, but we think there are still some good places to put money. The conservative sectors of the market that have underperformed this year look particularly attractive. Consumer staples and utility stocks are two areas that we think are worth buying. Heinz, Kimberly-Clark, Eli Lilly, Bristol-Myers, Southern Co. and Connecticut Water all yield more than ten year treasury bonds and unlike treasuries; they have a history of increasing their dividends and growing their principal.

In a recent presentation I had the chance to attend, the father of long term investing, Jeremy Siegel, cited attractive stock yields versus treasuries as a reason to be bullish. The following is what I wish he would have said if some of his toughest critics had been asking the questions.

THE FATHER OF LONG TERM INVESTING MEETS HIS HARSHTEST CRITICS

I recently moderated (in my mind) an investment forum in which two of the most influential critics of long term investing confronted Jeremy Siegel, its most influential proponent. Challenging Siegel were Nassim Taleb, author of *The Black Swan*, the definitive treatise on the folly of trusting long term trends and Jim Cramer, the notorious MSNBC talk show host.

Moderator (me): Dr. Siegel it is a pleasure to have you here. Jeremy Siegel is a distinguished professor of finance at the Wharton School of Business and author of *Stocks for the Long Run*, a work that has influenced a whole generation of investors, financial planners and money managers. Dr. Siegel's central argument is that stocks offer superior returns with less risk than other investments.

Dr. Siegel: Thank you Mr. Matthes. First, let me say that I have always admired your work and can't wait to read your next newsletter. In the first edition of my book's preface, I gave credit to Edger Lawrence Smith, who in 1924 wrote *Common Stocks as Long Term Investments*. Smith reached much

the same conclusions that I did regarding investing in various asset classes. His work was held in great esteem prior to the crash of '29 and then fell into near universal disrepute during the great depression. When I wrote my book, I did not anticipate that like Smith, I would be widely praised during the bull market of the nineties and ridiculed during the retrenchment that has marked the last decade.

The point I would like to make is that the recent performance of the equity markets in no way alters my conclusions. While it is disappointing that stock market returns have been basically flat over the past decade, they are well within the statistical probabilities I postulated in 1994. The fact that stocks underperform other assets a few times a century, in no way negates the finding that for the past two hundred years, stocks have outperformed all other asset classes so often, that the exception is a remarkable event. One ignores past experience at one's peril. My examination of financial markets dating back to the early eighteenth century makes it absolutely clear that equities offer superior returns with less risk than alternative investments for anyone with a ten to twenty year time horizon.

Moderator: Thank you Dr. Siegel. Now let's hear from our distinguished panel. First, Nassim Taleb, author of the *The Black Swan* and *Foiled by Randomness*, two of the past decade's most influential books. Nassim, would you like to comment on Dr. Siegel's thesis?

Taleb: Thank you Mr. Matthes. In my last book I wrote: "My principal activity is to tease those who take themselves, or the quality of their knowledge, seriously." So, please indulge me. Professor, I believe that your certainty is based on flawed science that yields erroneous conclusions.

In every prospectus I have ever read, there is a clause that says "past performance may not be indicative of future results." This is required by the financial authorities to warn unsophisticated investors, that what has happened in the past, might not happen in the future, yet you are asking us to believe just that. There are many reasons to believe that the future may look very different from the past.

You have created a statistical paradigm from the past performance of the US market, but you have conveniently not included markets that have done much worse than America, or don't even exist today. An equity investor in Greece, Argentina, Russia, Germany, Cuba and any number of other countries lost everything while the US markets were prospering. Is that included in your probability theory? No, your work is riddled with "winner's bias." You are just looking at the one country that has dominated the last century and saying that will happen in the next century.

While we are at it, what is the use of probability theory anyway, when we are talking about people's ability to live productive lives or not? If the odds of financial ruin are 5%, is that a small enough chance to risk it? Is 10% too much? What if you're wrong and the chances of losing everything are twice or three times what you have calculated? The world is a much more dangerous place than statisticians describe in their ideal worlds. Trusting the false logic of historical statistical analysis with one's financial future is sheer folly.

Siegel: Nassim, I appreciate your contribution to our shared desire to educate investors, but let's face it. Saying that s... happens is hardly revolutionary. Yes, the world is a dangerous place and there have been great tragedies throughout history, but where does that get us? What an investor needs to know is, what course of action is most likely to succeed. That is what my work is about.

Moderator: Now, let's bring in Jim Cramer, the popular host of CNBC's *Mad Money* and author of numerous books on investing. Jim, would you like to comment on Dr. Siegel's work?

Cramer: Sure. Long term investing is dead, if it ever worked. Only an ignorant sucker would hold stocks in a bear market. The stock market is a game with winners and losers. The winners are the ones who get in when the market is going up and out when it's going down. How hard is that to understand?

Long term investing is just "buy and hold" by another name and that's suicidal in a market that is as chaotic as this one. My listeners understand that to beat the market you have to be a player, not a passive passenger on the train to nowhere. When stocks are going up why not make money hand over fist by owning what's hot? There's always plenty of time to get out before any real damage is done when the market turns. I have a great record of making these calls for my listeners.

Siegel: Jim, you're either an idiot or a charlatan. I think you're a pretty smart guy, so I can only assume that you are purposely misleading the American people for your own benefit. **There is no...let me repeat that; no, none, not a sliver of evidence that you, or anyone like you, has any ability to predict the near term or intermediate term direction of the market.** Quite the contrary, every independent study ever done of predictions like yours found that they are at best, useless and generally harmful. I guess if you call a show *Mad Money*, you consider that a disclaimer that lets you get away with anything.

Cramer: I wasn't the pied piper of stocks, who led the gullible and naïve to their financial destruction.

Siegel: No, you're just another get rich quick scam artist with a national TV show!

Taleb: It is music to my ears to hear two stock jockeys ripping each other apart. Have either of you ever thought that maybe you're both wrong, and it won't matter whether you buy and hold stocks or trade stocks, you'll both lose money?

Moderator: OK, Mr. Taleb let's hear the bearish case for equities. The market is up 70% from its lows, the economy is recovering, but I take it you still think that the stock market is a bad investment?

Taleb: Unlike Mr. Cramer I don't make predictions about the market and unlike Dr. Siegel, I don't trust past performance as an indicator of the future, but I do know that risk is being wildly underestimated. I believe that at the current level, the equity market offers too little reward for the risks investors are being asked to take.

Specifically, I would point out that the world is beginning a great transformation of economic and political power from West to East, from traditionally structured corporations to emerging market moguls, from countries with rapidly aging populations to countries with better demographics. Maybe this will all turn out just fine, but history says such changes seldom occur without major dislocations. Which is why studying the past hundred years of American history is of little use when trying to predict what will happen over the next hundred years, or even the next ten years.

Siegel: Nassim, if that is your best argument against long term investing, I will call my broker tomorrow and sell the last bond I own to buy more stocks.

Taleb: I thought you already did.

Siegel: **The great transformation you are talking about is the very reason to expect that the next hundred years will be better for western capitalism than the past hundred.** The next hundred years may have some problems, but the past hundred saw the two world wars, the great depression, numerous panics and crashes, the fall of the British Empire and the rise of communism. Will it get worse than that?

Taleb: The US won both wars.

Siegel: Look Nassim, the world is experiencing the greatest period of economic growth in history. More people and a greater percentage of the world's population moved out of poverty in the past decade than ever before. The world's economies are embracing some form of capitalism, freeing their citizens from the slavery of communism and totalitarian regimes, benefitting not only the poor, but developed countries as well.

Far from being a threat to Western capitalism, the emerging countries of the East and South are our salvation because new markets are what every corporation wants. Do you think Cisco is worried about too much growth of the internet in China? Do you think Nike isn't happy that every day a couple thousand more Indians can afford its shoes? Who's the role model for South America, Venezuela or Brazil? 50% of the earnings of the S&P 500 come from overseas now. Wake up to the new reality!

Cramer: Jeremy's right, I've been making a killing on all that foreign stuff. They have some really hot markets that you can trade after ours close, so you can bet on news and hot tips 24/7.

Siegel: Jim, I take it back, you **are** an idiot!

Moderator: OK, we can agree that Jim's an idiot (Cramer is seen gesticulating wildly, but his mike has been cut off after his first expletive and he leaves.) Can we move on to the more serious business of how each of you would allocate retirement money today and why?

Taleb: I recommended cash, short term bonds and a small allocation to technology and biotech stocks.

Moderator: **So, 80% of your money is under the bed earning almost nothing and the other 20% is in things that could disappear overnight?**

Taleb: Right, but let me explain. If you believe, as I do, that there is a greater likelihood of something unforeseen happening, the arrival of the "black swan," then this is a perfectly logical asset allocation. Something really marvelous could happen. A biotech company could find the cure for cancer, or we could find a new form of cheap energy, but it's also likely that the whole financial system goes up in flames. My asset allocation covers both of these possibilities..

Siegel: But Nassim, what if you didn't have a big bonus check from your hedge fund and unlimited income from speaking engagements to the booming ranks of followers looking for the next apocalypse, the way you do? What if you needed some income and more importantly, needed some growth, so you didn't outlive your savings and maybe would be able to pass on something to your kids? At today's interest rates, a normal person who followed your advice would be spending at least 4 or 5% and almost nothing would be coming in. The world might not come to an end, but your money surely would.

My recommendation is that the vast majority of an investor's long term assets should be in a well diversified stock portfolio. Most investors have a need for short term assets for cash needs and bonds for

income but that's not where their growth will come from. Real estate and hard assets may have their place, but I have found that they are really inferior investments compared to equities.

Moderator: Maybe there's a compromise we could make here. Since Nassim and Jeremy agree that we can't expect to trade our way out of the next financial calamity, we need to have a serious understanding of the risk of a chosen portfolio allocation and live with it.

Siegel: I did that. I calculated the chances of market corrections using data stretching back two hundred years and applying rigorous statistical analysis to describe the risk of owning a range of investments.

Taleb: But it's bogus!

Moderator: Let's just say that it's less than everything we need to know to help people invest their money. Statistics, as you have so wisely pointed out Nassim, have their limitations. The greatest being, that since they are based on the past, they fail to anticipate major changes that may influence the future. The analogy I have used before is; if you are living on the side of a volcano it starts to rumble, you don't need a statistician to compute historical data based on past performance, you need a geologist.

Taleb: My point exactly!

Moderator: Yes Nassim, but most people don't have the luxury of waiting for black swans to swim by to be right. So, let me propose a compromise for investors who admire both your work. Jeremy, you are probably right to say that most people overestimate the risk of owning stocks. But Nassim, the fact that the stock market has performed poorly for the past decade is hardly proof that past returns are irrelevant. There is no question that the shorter the time horizon, the more conservative a prudent man has to be. There is also no question that despite our best efforts to set appropriate time horizons and diversify portfolios, disasters can still happen.

Taleb and Siegel in unison: So?

Moderator: So, a prudent investor does three things. One, he (she) tries to mitigate risk by considering investments in stocks as long term assets, the price of which will gyrate erratically over the short term, and only approach investment status over a ten to twenty year time horizon.

Siegel: Exactly what I said!

Taleb: Yes, you said it but nobody listened to the long term part. And, what about my black swans?

Moderator: Thanks Nassim. Secondly, the prudent investor understands that although long term investing brings much greater certainty, the consequences of being wrong are at least geometrically more consequential than statistics alone would suggest.

Taleb: Exactly what I said. If you happen to be among the 5% of investors who have their life savings wiped out by the market, the fact that it was an unlikely event, long or short run, is irrelevant.

Moderator: Well said Nassim, everybody has his own tolerance for risk, income and wealth requirements. If you need to have a certain amount of money, or a fixed amount of income at a certain date, buy really safe instruments or risk being disappointed. If that disappointment would turn into a personal disaster, don't even think of buying anything except short term government bonds.

Siegel: I never said anything different than that. I just pointed out that stocks have done much better, with much less risk than bonds, cash, real estate or commodities.

Moderator: **Jeremy you make one other really great point in your book which leads me to my third piece of advice to prudent investors. NOTHING IS ABSOLUTELY SAFE, SO YOU HAVE TO PICK YOU RISKS WISELY.** Jeremy, do they still use the phrase “risk free rate of return” to describe T-bill and money market rates at Wharton?

Siegel: I’m afraid they do, but not in my classes. I won’t let my students talk that gibberish, because short term debt is the lowest yielding of all financial assets with the exception of gold. Additionally, it can be the riskiest of all assets to hold in an inflationary environment, which is what we are likely to see, once this recession is over. Then too, as you said earlier, if you need to live on 6%, but short term rates are 1% and inflation is 2%, what’s safe about spending 7% more than you make a year in real dollars?

Moderator: True. So, risk is more than just how much you can lose in any one year, which would make T-bills very safe and stocks very risky. Rather, for long term investors, it’s the range of inflation adjusted probable returns, which makes T-bills more risky than stocks.

Taleb: Did Jeremy pay you off? How many times do I have to prove that risk is more than just probability based on historical data?

Moderator: Yes, but given a whole range of likely economic scenarios, your portfolio of mostly short term bonds would be a disaster. That’s a risk most people can’t take. You have admitted in both your books that your ultra-contrarian style is wrong most of time. Investors need an investment plan that works consistently, not just when the black swan arrives.

Taleb: I never meant my books to be financial planning bibles for the masses.

Siegel: You can’t trade your risk away the way Cramer thinks you can. Most people can’t afford to put the bulk of their money under their bed and wait for a rare event the way Nassim advocates. If you think I’m underestimating the risk of owning equities, what’s an investor to do?

Moderator: **I recommend that money that can’t be lost be put in the safest assets possible, but I also recognize that that some risk is unavoidable.** For most people, a balance of stocks, bonds and cash can be devised that meets their needs for growth, income and safety. If investors really understand the risks inherent in various investment options, a balance can be reached. The dangerous course is to think that there is some holy grail of investing that will eliminate risk, give outsized returns or worse yet, do both.

Thank you, I don’t think we solved the investment conundrum, but we hopefully shed some light on it.

William Matthes

The information herein has been obtained from sources believed to be reliable, but we cannot guarantee its accuracy or completeness. Past performance is no guarantee of future results. Neither the information nor any opinion expressed constitutes a solicitation for the purchase or sale of any security. Westport Resources Management, Inc. is an Investment Advisor registered with the SEC.