Quarterly Capital Markets Commentary

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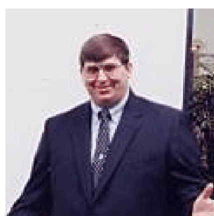

From The Research Desk

by Ron A. Rhoades, B.S., J.D.
CCO and Director of Research,
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Stock Market Downturns And The Desire To Flee

Risk is real.

Especially for the modern-day investor.

The Largest Factor Affecting Investment Returns. Overwhelming academic evidence indicates that the asset allocation decision is the most important determinant of the gross investment returns (i.e., returns before fees, expenses, and taxes). Other academic research has clearly demonstrated that higher-cost investment strategies, such as "actively managed mutual funds" whose total average costs (including disclosed costs, internal transaction costs, and opportunity costs) can easily be 3% or more a year, are doomed to underperform lower-cost, "passive" investment strategies in the same asset class over long periods of time and on average. Still other research has revealed a significant drain on investor net returns from "tax drag," often causing even more damage to the investor's long-term net returns than high expenses. However, we would suggest another, and perhaps more significant factor, also affects investment returns. ***In fact, this may be the most important determinant of the actual investment returns an investor will realize***. As explained below, this is also the most difficult major factor for our firm to manage. What is this major factor? Simply this - the "fight or flight" mechanism each individual possesses. In this article we examine this fear-driven emotional response to negative surprises. Understanding how people react emotionally to events is often key to undertaking proper action.

The "Fight or Flight" Mechanism. The "fight or flight response" is our body's primitive, automatic, inborn response that prepares the body to "fight" or "flee" from perceived attack, harm or threat to our survival. Originally discovered by the great Harvard physiologist Walter Cannon, this response is hard-wired into our brains and represents a genetic wisdom designed to protect us from bodily harm. This response actually corresponds to an area of our brain called the hypothalamus, which—when stimulated—initiates a sequence of nerve cell firing and chemical release that prepares our body for running or fighting. For ancient man, when a beast approached, this essential mechanism often served to ensure survival. For modern man this mechanism still serves a useful purpose at times, but it can also cause an individual person harm.

The World Has Changed. It's a different world than that which existed for our distant ancestors. No longer do we have to deal with large beasts who desire to consume us (except for those intrepid few who occasionally go on safaris).

It's also a far different world than that which existed for our current retiree clients than the financial world which existed for many of these clients' own parents. Instead of a monthly pension, many retirees today are faced with the challenge of accumulating and then managing a "nest egg" of investment funds. The individual investor must determine reasonable rates of withdrawal during retirement, a task made far more difficult by increased volatility in the capital markets during the last 10-15 years and by the increases in average life expectancy.

The Nest Egg and The Perceived Threat. Into this new reality of managing a nest egg arise our own individual emotional reactions. Take this scenario, for instance. The stock market tumbles, and stock or stock mutual fund values fall. Or interest rates rise, causing bond values to fall. The monthly or quarterly statement arrives from Charles Schwab, Vanguard, Ameritrade or some other custodial brokerage firm, showing the decline in these values. Instead of a peaceful walk back from the mailbox (as was the case with the arrival of the monthly pension check), panic begins to set in. The typical thought process can be summarized as follows: "Danger!!! Danger!!! The Nest Egg Has Shrunk!!! What am I to do?"

In fact, the brain tells the investor that something must be done. As the body reacts to the danger the investor becomes prepared — both physically and psychologically — for fight or flight. The investor begins to scan and search our environment, "looking for the enemy." The option of fighting seems out. So, the mind resorts to the second option - *flight*.

For many investors, glued to CNBC or CNNfN, or watching their investment portfolio daily on the internet, the stress of declines in the values of investments can be even greater. Over many days or weeks the investor is forced to constantly deal with the ever-growing danger. The investor, subjected to the flight stimuli over and over again, can easily be driven to a state of despondency or depression.

The Flight Response And The Individual Investor. When our flight system is activated we tend to perceive everything in our environment as a possible threat to our survival. By its very nature, the fight or flight system bypasses our rational mind—where our more well thought out beliefs exist—and moves us into "attack" mode. This state of alert causes us to perceive almost everything in our world as a possible threat to our survival. As such, we tend to see everyone and everything as a possible enemy. We may overreact to the slightest comment. Our fear is exaggerated. Our thinking is distorted. We see everything through the filter of possible danger. We narrow our focus to those things that can harm us. Fear becomes the lens through which we see the world.

See how it is almost impossible to undertake rational decisions when we enter this survival mode? During the fight or flight mode we are focused on short-term survival, not the long-term consequences of our actions. And therein lies the problem for the long-term investor.

Why Invest in Stocks? Over very long periods of time (often 15-20 years or more), a broadly diversified basket of stocks is extremely likely to substantially outperform inflation. By contrast, putting the money into bonds, CDs, or other "safe" investments (like stuffing cash under the mattress) is not likely to significantly outpace inflation. (Please refer to chart on the next page.) Also, since unrealized capital gains in stocks are deferred until the stock is sold, and then (under current tax law) taxed at favorable tax rates when sold, stocks can often be a more tax-efficient way to invest over the long-term than fixed income investments.

Simply put, what $1.00 buys today may require $2.00 in 20 years. The need to outpace inflation, in order to be able to grow the investment portfolio over long periods of time while enabling a reasonable rate of withdrawal, is the core reason behind stock investing. Additionally, a retiree's *personal rate of inflation* is likely to be higher than the "consumer price index," as health care expenses (only a small part of the CPI number) are likely to consume a larger portion of a retiree's income and such expenses are likely to rise faster than the rate of inflation.

The Impact of Inflation (as of May 2004)	
To buy the same goods purchased in 1990 for $1.00, you would need (in today's dollars):	$1.50
To buy the same goods purchased in 1980 for $1.00, you would need (in today's dollars):	$2.37
To buy the same goods purchased in 1970 for $1.00, you would need (in today's dollars):	$5.03
To buy the same goods purchased in 1960 for $1.00, you would need (in today's dollars):	$6.46
To buy the same goods purchased in 1950 for $1.00, you would need (in today's dollars):	$8.03

Source: DFA Returns Program, using CPI-U data supplied by Stocks, Bonds, Bills and Inflation, a publication of Ibbotson Associates. All data is © 2004 by the foregoing. All Rights Reserved. Data used under license from Dimensional. This data is supplied for educational purposes only.

U.S. BONDS VS. U.S. STOCKS HISTORICAL RETURNS COMPARISON: GROWTH OF $1.00 TO MAY 31, 2004							
Time Period	Inflation (CPI) (Equivalent Purchasing Power Needed for $1.00 at beginning of the period)	1-Month Certificates of Deposit	Long Term U.S. Corporate Bonds	S&P 500 Index	Large Cap Value Stocks (Fama-French Big High Portfolio)	Small Cap Stocks (Fama-French Small Medium Portfolio)	Small Cap Value Stocks (Fama-French Small High Portfolio)
1/1950-5/2004	$8.03	$19.17	$26.80	$480.71	$1,481.00	$2,084.00	$6,092.00
1/1960-5/2004	$6.46	$15.47	$24.25	$81.94	$199.55	$374.49	$984.62
1/1970-5/2004	$5.03	$9.98	$20.53	$38.62	$71.99	$107.61	$235.50
1/1980-5/2004	$2.47	$4.91	$11.22	$21.85	$22.71	$40.84	$58.36
1/1990-5/2004	$1.50	$1.86	$3.30	$4.34	$3.60	$6.88	$8.60
1/2000-5/2004	$1.12	$1.15	$1.51	$0.81	$0.98	$1.80	$2.22

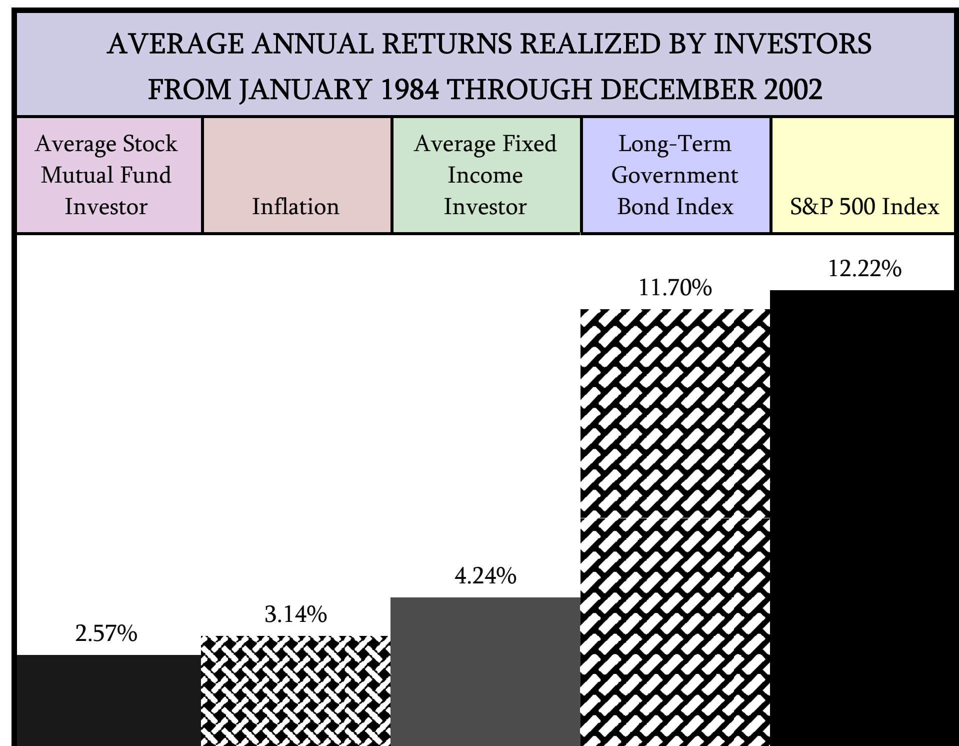
Source: DFA Returns Program, Ibbotson Associates, Center for Research In Security Prices, Professor Eugene Fama, Sr. and Professor Kenneth R. French. All data © 2004 by the foregoing. All Rights Reserved. Data used under license from Dimensional. Past performance is not a guarantee of future results. The foregoing returns results are based upon data for indices, not actual mutual funds, and hence do not reflect various costs, fees, and economic risks associated with investing. This data is supplied for educational purposes only.

See any problem developing here? The rational investor knows that investing in a broadly diversified basket of stocks is a key - perhaps the major key - in the ability to keep pace with inflation and sustain a reasonable rate of withdrawal from the investment portfolio. But as stock prices fall in the short term, here comes that flight mechanism, causing the investor to often cast aside rational thoughts and instead "flee the market" - selling stock mutual funds and investing in "safer" investments. The psychological response our body is subjected to casts aside reasoned plans and focuses on the short-term, not the long-term.

Recent Evidence From Our Own Experience As Investment Advisors. At Joseph Capital our investment advisors observed a lot of this flight mechanism in recent years. In late 2002 we were alarmed at the number of new prospects we saw who had just recently left the stock market altogether. After suffering two years or longer of negative stock market returns these investors finally gave in to the flight response. Still "fearful" of the dangers their minds told them was out there, they refused to even consider investing in the stock market, even though in many cases the investors had 25, 35 or more years to make their nest egg last. If we were unable to convince these prospects otherwise, we did not take them on as clients. Interestingly enough, many of these same investors called us a year later - after the substantial stock market gains of early and mid-2003. In the minds of these investors the stock market was no longer dangerous. How could it be, when it had recently gone up significantly? The "fear" of stock market investing was gone. (Interestingly enough, when the stock market goes up rapidly, as large company stocks did between 1995 and 1999, and as nearly every stock asset class did in 2003, the risk of stock market investing actually go up, as the prospects for sharp downturns in future years increase and expected returns over the next 10-15 years become lower.)

"*Motivated by fear and greed, investors pour money into equity funds on market upswings and are quick to sell on downturns. Most investors are unable to profitably time the market and are left with equity fund returns lower than inflation.*"

- 2003 update to DALBAR study, "Quantitative Analysis of Investor Behavior" (Study results shown in table)



The Devastating Impact of Pulling In and Out of The Market. Can investors (or professionals) time the market? The evidence is clear - they cannot. In fact, attempts at market timing usually leads to decisions based upon emotional reactions (*i.e.*, greed, fear). ***As a result of permitting emotions to dictate investment decisions, the average stock mutual fund investor today receives a far less return (2.57% average annualized return, from Jan. 1984 through Dec. 2002) than the capital markets offer (12.22% for the S&P 500 index over the same time period, for example). (See the study results, above.)***

The Importance of A Disciplined Investment Process. Let's seek to put this all in perspective. The most important determinant of realized results is, for the individual investor, the ability to adhere to whatever asset allocation is selected when the investment policy is designed.

What does the "design" of an "investment policy" require, in practice? A series of analytical steps, including but not limited to the following:

First, we must determine how much risk - i.e., exposure to the stock market - is required to achieve your personal financial goals? If you only need to be 40% in stocks in order to generate the returns needed, why take on more risk?

Second, we should examine *your personal tolerance* for volatility. If you can endure a greater amount of volatility than you require, this might permit a slightly more aggressive allocation. If, however, your tolerance for portfolio volatility is quite low, we may examine more closely how we can adjust your spending habits to enable a lower allocation of your portfolio to stocks.

Third, will you accept a "tilting" of your portfolio toward "small cap" and "value" stock asset classes, as a means of securing greater expected long-term returns? In this regard, how would you likely react if U.S. large cap

growth stocks were up substantially, while small cap and value stocks were not up as high (as occurred in 1995-1999)? Would you be willing to adhere to the discipline? (If the investor from 1995-1999 adhered to the small cap and value tilt, the investor would be aptly rewarded during 2000-2002 when U.S. large cap growth stocks tumbled severely, while value and small cap stocks performed much better.)

Fourth, if we can tilt your portfolio in the direction of "small cap" and "value" - either modestly or greatly - can we then lower your allocation to stock mutual funds (and increase your allocation to fixed income investments)? This would be our choice. (For more on this decision, please refer to our January 2004 Quarterly Capital Markets Commentary.)

Fifth, we all need to realize that we are not able to predict short-term market movements. Simply because the stock market went up today, or each day for the past two weeks, does not provide us any reliable information about what the stock market will do tomorrow. Conversely, simply because the stock market is down significantly, this does not mean that the stock market will continue to go down. (Witness the substantial rebound in 2003 after the 2000-2002 large cap decline, or the large rebound in 1975 after the decline in nearly all stock asset classes in 1973-1974). In essence, we must be *humble* about our abilities. We believe ourselves to be educated, informed, and serious about our study of the capital markets. However, our humility forces us to accept that we are not fortune-tellers. And the academic evidence clearly demonstrates that no one else is, either.

Sixth, with all of those realizations we must adopt an investment strategy designed to meet the particular short-term and long-term needs of each investor. Academic research has shown that the best manner of designing investment strategy is to adopt a strategic asset allocation - and stick with it. Modifications to an investor's strategic asset allocation should only be made if a fundamental change occurs in the investor's situation (which can occur every few years or so), or in the capital markets (which is very rare, despite many assertions to the contrary).

Seventh, as a means of keeping the investor's portfolio properly allocated to achieve the investor's goals, we must periodically rebalance the portfolio, as tax-efficiently and cost-efficiently as may be possible.

It is this final step in the investment advisory process that some of our clients find most difficult. The stock market is down, and we are telling them to rebalance their investment portfolio and buy more! But emotionally the investor client is reacting to that flight mechanism! [*The investor client asks, "Why should I buy more of something when every bone in my body tells me I should flee? Conversely, why should I sell stocks (and take gains off the table)when stocks are up and my emotions confirm for me that stock investing is now safe?"*] In essence, we know we are asking our clients to act in a way which their emotions suggest, at times, is not proper. But reason and rational thought will, we hope, prevail. A disciplined approach to portfolio rebalancing permits us to "buy high" and to "buy low." Instead of emotional reactions to short-term stock market swings, we seek to have our clients *stick with the non-emotional disciplined process we have adopted*. Hmm ... buy low, sell high ... isn't that often said to be the key to investment success?

The most important determinant of realized results is, for the individual investor, the ability to adhere to whatever asset allocation is selected when the investment policy is designed.

Controlling The Controllable. At Joseph Capital Management, LLC we believe that many factors affecting investment risks and returns can, to a large degree, be controlled and managed. Nevertheless, the process of managing investment portfolios for our clients and acting as stewards of their wealth can be complicated. For each client we must address their unique individual needs, lifetime financial goals, and estate and asset protection planning needs.

While each client's needs are unique, the body of knowledge and expertise required to be applied is both broad and ever-changing. Through our team-oriented, multi-disciplinary approach, we act to keep abreast of the ever-changing economic, financial, tax and legal climate. This involves several continual activities which enable us to seek to "control the controllable":

- We review the new academic research which constantly arrives in the worlds of economics, risk measurement, and financial theory, paying particular attention to such areas as strategic asset allocation and risk reduction. We then seek to apply that research (once confirmed and accepted by the academic community at large) to the practical design of customized investment portfolios for our clients, realizing that our clients live in the "real world" while not all academics are so fortunate.

- We constantly review the investment product universe, searching out those investment products which are best designed, in our view, to capture the returns a capital asset class has to offer while keeping overall expenses low. Only a relatively few investment products are on our "approved" list of investments. Another dozen or more investment products are usually under scrutiny and receive ongoing analysis as possible additions to our approved list. Already approved investments are periodically reviewed for their continued suitability.

- Once a product is selected as being good for the individual investor, we need to be able to obtain it for the benefit of our clients. Through our firm's independence, we can access nearly every investment product available to individual investors today. In addition, we provide access for our clients to institutional-style mutual funds not ordinarily directly available to individual investors today. As we refuse all payments from product providers and are paid only by our clients, we avoid the conflicts of interest so common at stock brokerage firms. This maintains our objectivity, which we believe to be imperative to adhere to our fiduciary duties to our clients.

- With our broad knowledge of income, estate and gift taxes, including retirement account distribution planning, we seek to also lower the long-term tax burdens facing investors. We keep track of ever-changing tax laws and tax and legal strategies. In essence, we seek to enable our clients to "keep more of what they make."

- Lastly, through continued education of you, our client, we seek to help you to control your emotions. Through our newsletters, commentaries, articles, books, annual group luncheon presentations, and private conferences, we hope to educate you. If we are successful in this, our most pressing initiative, you will learn how to manage the "flight or flee" mechanism and not permit it to interfere with the adopted investment strategy and discipline.

Despite All Of Our Efforts, The Future Is Uncertain. Although we can apply academic research to design and manage investment portfolios to reduce various risks, there is no way we can avoid all risks. Unfortunately, one of the most common and severe mistakes of investors is to treat the highly unlikely as impossible and the highly likely as certain. Prudent investors know that, just because something has not yet occurred, does not mean that it cannot or will not occur in the future. One need look no further than the events of September 11, 2001 for proof of this important point. By learning about and accepting the real potential for significant negative surprises, investors are much better prepared to cope with them should they actually occur. By learning about the "flight or flee" mechanism you should now more able to cope with market downturns, which will, inevitably, occur from time to time.

In Conclusion. Our messages are both simple and direct. Undertake proper planning at times when emotions do not override rational thought. Establish a proper investment discipline. Realize that your ancient ancestors were saved by the "fight or flight" mechanism, but in today's modern world at times this emotional reaction can often lead to poor decision-making. Don't try to predict the future of the stock market or of interest rates (unless you truly do possess a crystal ball). In other words, adopt a sound investment policy, and then stick with it.

Risk is real. The modern-day investor has a much greater chance of success when he or she is able to react appropriately when these risks become both apparent and pressing.

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