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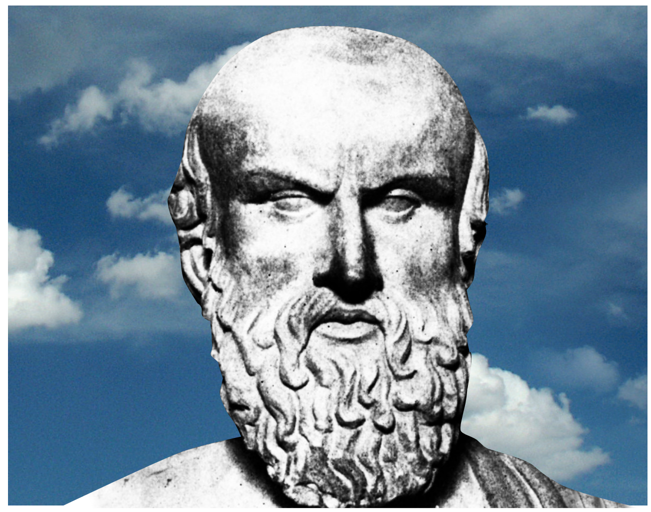
The Tortoise and The Eagle (An Investment Tale)

"Avoiding danger is no safer in the long run than outright exposure. The fearful are caught as often as the bold." - Helen Keller

The ancient Greek playwright Aeschylus was the recipient of a most disturbing prophecy: According to legend, he was told that he would be killed by a falling object. Believing that he could prevent the prophecy from coming to fruition, he elected to remain outdoors in open areas whenever possible. This strategy served him well until one fateful day when an eagle, searching for a way to kill its prey, mistook Aeschylus' bald head for a rock and dropped a tortoise on him.

The story of Aeschylus reminds us that, in an effort to seek safety, we can sometimes find danger in the most unlikely places. When investors seek safety in the financial markets, they tend to gravitate towards high quality bonds such as US Treasuries. Unlike stocks, most bonds pay interest regularly and return principal on a predetermined future maturity date. These regular fixed payments and full return of principal provide a far more predictable outcome than the wild gyrations of the stock market, so investors tend to presume that a portfolio of bonds is a safe portfolio. However, bonds carry several subtle risks of their own which many investors may not fully appreciate.

Suppose Jack buys a ten-year government bond today at 3%. This sounds safe enough: Jack collects 3% annual interest for ten years, then he gets his money back; what could possibly go wrong? The problem is, Jack has locked in that 3% interest rate for ten years. If the rate of interest on new government bonds increases



to 5% next year, Jack will be stuck with a bond that pays 2% less than the market rate for nine more years.

"No problem," Jack says. "I will just sell the bond to Janet if interest rates go up." Unfortunately for Jack, this is a problem, because Janet (who is not an altruist) will not buy his 3% bond when she can buy a 5% bond from somewhere else. Jack will need to lower the price of his bond significantly in order to entice Janet (or any other individual) to buy it. The precise mathematics of bond pricing is quite complicated, but a rough approximation will illustrate the point: If Jack wants someone to buy a bond that pays 2% below the market rate for nine years, he will have to discount his bond by 18% (2% x 9 years) to make the buyer whole. That's right; the value of Jack's bond will decline by 18% in this scenario. He either has to accept a permanent loss of 18% to get out of the bond, or he has to live with a low interest rate for many years to come. The existence of this significant risk comes as a great surprise to many bond investors.

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> ***"Being aware of risk and diversifying it across your portfolio typically leads to better investment results."***

Jack's example illustrates the most fundamental rule of bonds: Interest rates and bond prices move in opposite directions, and the longer the maturity of the bond, the larger the price move for a given change in interest rates. This is why, as interest rates have declined for many years, there has been talk of a "bond bubble." The concern is that, as interest rates begin to rise in the future, many bond investors will be stunned by the sudden dramatic losses they will likely experience in these "safe" assets. Because longer-maturity bonds are more sensitive to changing interest rates, a bond with a shorter maturity will provide a greater level of protection against principal loss in a rising rate environment. That said, even short-term bonds carry some element of risk.

This is not to suggest that you should avoid bonds altogether. Bonds are a critical component of any well-diversified investment portfolio because bond prices are usually not influenced by the same economic factors as stock prices. Therefore, bonds can help protect your portfolio from the wild swings in the stock market, and they will also provide a source of income and stability during prolonged periods of weakness in stocks. And, if you use bonds with short maturities, you can lower your risk of loss in a rising interest rate environment.

Aeschylus thought he was removing risk from his life. Unfortunately, he was only exchanging one form of risk for another. Avoiding stocks in favor of bonds will not protect you from all forms of risk, nor will avoiding bonds in favor of stocks. The best way to properly manage risk and to help protect on the downside is to hold some of all of these different assets. Being aware of risk and diversifying it across your portfolio typically leads to better investment results.

Aeschylus' decision to remain outdoors gave him a false sense of security. If he had concentrated on all falling objects rather than just the manmade kind, he may have survived. Diversifying your portfolio among stocks and bonds (and other asset classes as well) helps successfully manage risk in the long term and volatility in the short term. No one knows when interest rates will begin to rise or how much they will increase, but understanding the implications to your portfolio can help you avoid the proverbial tortoise on the head.

This article was originally written by Heritage for the March 2015 edition of The Light, a local magazine serving Broward County, Florida.

Connecting the Dots

Human beings love stories. But this innate tendency can lead us to imagine connections between events where none really exist. For financial journalists, manufacturing these connections is a virtual job requirement. For investors, it can be a disaster.

According to a recent report from Reuters, "The dollar fell on Wednesday...after the Bank of Japan kept monetary policy unchanged despite slowing inflation." Needing to create order from chaos, journalists often stick the word "after" between two events to imply causation. In this case, the implication is the dollar fell because the Bank of Japan kept its official interest rates unchanged.

Perhaps it did. Or perhaps the dollar was driven down by a speculator making a wager on US interest rate policy or a computerized trading program reversing a momentum trade. Markets can move for many reasons.

For many months now we have heard claims such as "stocks on Wall Street retreated today after an escalation of tensions in the Middle East." Again, how do we know that really was the cause? What might have happened is a trader answered a call from a journalist asking about the day's business and tossed out the Middle East as the reason for the fall because he was watching it on the news.

Sometimes, journalists will fabricate an imagined market reaction linked to an event which has yet to occur: "Stocks are expected to come under pressure this week as the US Federal Reserve meets to review monetary policy settings."

For individual investors, financial news can be distracting. All this linking of news events to very short-term stock price movements can lead us to think that if we study the news closely enough we can work out which way the market will move. But the jamming of often-unconnected events into a story can lead us to mix up causes and effects and focus on all the wrong things. In his book, *The Black Swan*, the writer and academic Nicholas Nassim Taleb came up with a name for this story-telling imperative: the narrative fallacy.

The narrative fallacy, which is linked to another behavior called confirmation bias, refers to our tendency to seize on vaguely coherent explanations for complex events and then to interpret every development in that light. These self-deceptions can make us construct flimsy, if superficially logical, stories around what has happened in the markets and project them into the future.

The financial media does this because it has to. Journalists are professionally inclined to extrapolate the incidental and specific to the systematic and general.

They will often derive universal patterns from what are really just random events. Building neat and tidy stories out of short-term price changes might be a good way to win ratings and readership, but it is not a good way to approach investing.

There is a saner approach, one that doesn't require you spending half your life watching CNBC and checking Bloomberg. This approach is methodical and research-based; a world away from the financial news circus.

The alternative consists of looking at data over long time periods and across different countries and multiple markets. The aim is to find factors that explain differences in returns. These return "dimensions" must be persistent and pervasive. Most of all, they must be cost-effective to capture in real-world portfolios.

This is not a traditionally active investment style where you focus on today's "story" and seek to profit from mistakes in prices, nor is it a passive index approach where you seek to match the returns of a widely followed benchmark. This is about building highly diversified portfolios around these dimensions of higher expected returns and implementing the strategy consistently and at low cost. It is about focusing on elements within your control and disregarding the daily media noise.

Admittedly, this is not a story that is going to grab headlines. Using the research-based method and imposing a very high burden of proof, this approach resists generalization, simplification, and using one-off events to jump to conclusions. But for most investors, it is the right story.

50 Years of Warren Buffett's Wisdom

For 50 years, Warren Buffett has been at the helm of Berkshire Hathaway, among the largest publicly held companies in the world, and for 50 years he has been publishing annual letters to shareholders. We do not typically focus on particular companies' annual announcements, nor do we typically share them as recommended reading, but Mr. Buffett's letters to Berkshire Hathaway shareholders are different.

While his letters lead with the usual corporate analytics, they are also generously seasoned with Buffett's legendary combination of wisdom and practicality on business, finance, family wealth, philanthropy, life lessons and "just for fun" jabs. Investment advice aside, they are simply fascinating reads from a thoughtful man who is leading a life well-lived. Here are a few of our favorite passages from this year's letter:

On American Enterprise…

"Charlie [Munger] and I have always considered a 'bet' on ever-rising U.S. prosperity to be very close to a sure thing. Indeed, who has ever benefited during the past 238 years by betting against America?"

"Though the preachers of pessimism prattle endlessly about America's problems, I've never seen one who wishes to emigrate (though I can think of a few for whom I would happily buy a one-way ticket)."

On Business Management…

"The [2014 Berkshire employee] increase, I am proud to say, included no gain at headquarters (where 25 people work). No sense going crazy."

"It's better to have a partial interest in the Hope Diamond than to own all of a rhinestone."

"We don't have a legal office nor departments that other companies take for granted: human relations, public relations, investor relations, strategy, acquisitions, you name it. We do, of course, have an active audit function; no sense being a damned fool."

On Wealth and Investing…

"Investors, of course, can, by their own behavior, make stock ownership highly risky. And many do."

"A sound investment can morph into a rash speculation if it is bought at an elevated price."

"You can't get rich trading a hundred-dollar bill for eight tens."

On Capital Markets…

"One of the heralded virtues of capitalism is that it efficiently allocates funds. The argument is that markets will direct investment to promising businesses and deny it to those destined to wither. That is true: With all its excesses, market-driven allocation of capital is usually far superior to any alternative."

"Periodically, financial markets will become divorced from reality – you can count on that."

"No advisor, economist, or TV commentator – and definitely not Charlie nor I – can tell you when chaos will occur. Market forecasters will fill your ear but will never fill your wallet."

On Risk Management…

"We will always be prepared for the thousand-year flood; in fact, if it occurs we will be selling life jackets to the unprepared."

"When bills come due, only cash is legal tender. Don't leave home without it."

"In our view, it is madness to risk losing what you need in pursuing what you simply desire."

"Market forecasters will fill your ear but will never fill your wallet."

On Ethics and Conflicts of Interest…

"If horses had controlled investment decisions, there would have been no auto industry."

"Money flows from the gullible to the fraudster. And with stocks, unlike chain letters, the sums hijacked can be staggering."

On Human Nature…

"Charlie told me long ago to never underestimate the man who overestimates himself."

"To have our fellow owners – large and small [shareholders] – be so in sync with our managerial philosophy is both remarkable and rewarding. I am a lucky fellow to have you as partners."