



Template for a Mid-Year Letter – Navigating through this Calamitous Decade

By Dan Richards
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It's always important for clients to feel they're being kept informed of what's happening in markets – but never more so than in markets like we've seen in the past few months.

What follows is a template for a mid-year market commentary to clients, for you to adapt to your own opinions and circumstances.

Some things to bear in mind:

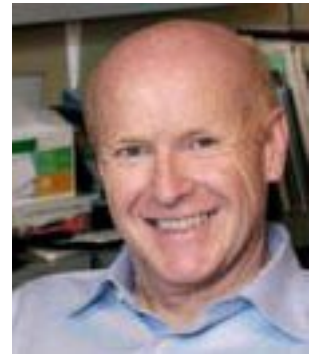
1. This letter is positioned as coming from an individual advisor – if clients deal with multiple members of a team, you might change “I” to “we” wherever it appears.
2. This letter maintains a fine line in terms of length – long enough to be substantive but short enough for most clients to read. This is of course subjective – although I wouldn't make this letter any longer, some advisors will want to trim the length back.
3. I've included a chart as an addendum to make the point about the relationship between holding period and volatility of returns – some advisors may want to eliminate this to reduce the letter's length.

4. And most important:

Every quarter, I remind advisors of the critical importance of customizing this letter to your views and approach – one of the things clients look for in these kinds of communication is their advisor's voice and personality.

Note that this is especially important on the bottom of page 3, where there is a discussion of current valuation levels.

As always, it takes time to customize this kind of letter to your views – but that time will be one of the better investments you'll make in the next while.





July 2010

A mid-year letter to clients:

Navigating through this “calamitous decade” ...

Perspectives from the father of value investing

After 2008’s sharp decline and last year’s recovery in stock markets, many had hoped that 2010 would see a return to relative normalcy and stability.

And certainly, the year started on a positive note, as stocks turned in one of the strongest first quarter increases on record.

Then, in rapid succession came:

- The intensification of the budget crisis in Greece that arose in February, with the risk of contagion across Europe;
- Concerns that European budget cuts would slow down economies, with spillover effects globally; this is especially problematic in light of the need to compete with a devalued euro;
- Growing fears about a housing bubble in China;
- The April 22 sinking of a BP oil drilling rig in the Gulf of Mexico; and
- The May 6 “flash crash” in which US markets plummeted in a matter of minutes without explanation.

Looking at these events, it’s tempting to ask what the next catastrophe will be. In fact, based on these last six months, history may view this as “the calamitous decade,” even though we’re only 5% into it.

In talking to our clients about how portfolios should be positioned in light of this, we point to three guiding principles from Benjamin Graham, considered the father of value investing.

Starting in 1926, Graham taught at Columbia University and wrote on investments for thirty years, bringing a new level of rigor to security analysis. His views and approach shaped a generation of money managers, among them Warren Buffett, who enrolled at Columbia with the explicit goal of studying with Graham and who joined his firm after graduation. In fact, Buffett describes Graham’s book *The Intelligent Investor* as the best book on investing ever written.



Recently, financial journalist Jason Zweig unearthed a 1963 talk by Graham that he posted on his website.

Titled *Securities in an Insecure World*, Graham's talk reminds us of guiding principles that investors always need to bear in mind.

I focus on three of these principles in chaotic times like those of late.

Principle one: Invest in stocks and bonds only so far as you can live with fluctuations in prices

This principle is based on the idea that investors have to understand their own ability to live with volatility.

Investors were reminded of this in 2008 – many investors discovered their true risk tolerance in that market.

In the concluding remarks to his 1963 talk, Graham mentioned an old Wall Street adage that whenever clients asked a broker to recommend stocks to buy, he'd answer by saying: "Do you want to eat well or sleep well? That will determine what I recommend."

Graham went on to say that by following sound policies, almost any investor should be able to eat well without losing any sleep – even in the insecure world of 1963, shortly after the Cuban missile crisis.

I share Benjamin Graham's view on the need to both eat well and sleep well – my goal with every client is to tailor a portfolio that achieves these dual and sometimes contradictory objectives.

And to help retired clients maintain peace of mind during periods of volatility, I normally recommend that three years of cash needs (from savings) be kept in liquid, safe investments.

Principle two: The price you pay when you buy stocks is key

There are many factors that determine how investments perform over time – but few are more important than paying a reasonable price when you buy. After all, people who bought companies like Cisco, Intel and Microsoft 10 years ago (at the height of the dot-com bubble) have lost half their money – not because these aren't exceptional companies, but because the price they paid was too high.

In his talk, Graham said that investors should always have an allocation to stocks, bonds and cash. The minimum level for stocks should be 25% and the maximum 75% - and the



amount should be determined by value considerations, owning more common stocks when the market seems low in relation to value and less when the market appears expensive.

There are many contradictory views on today's valuation levels.

Customize the next section to your own views

In his speech, Benjamin Graham outlined a methodology for valuing markets. Depending on your assumptions, it suggests that fair value for stocks today, given current low interest rates, could be as high as 23 times average earnings over the past ten years.

By contrast, the most current data based on the last 10 years of earnings for US stocks, adjusted for inflation, from Yale economist Robert Shiller puts this multiple at 20 times. This would suggest that the market is fairly valued – and if we see a continuation in profit increases as the economic recovery continues, today's prices may end up being viewed as quite inexpensive.

Principle three: Long-term goals demand long-term thinking

Graham's student Warren Buffett has said that it only takes two things to make money – having a sound plan and sticking to it ... and that of those two, it's the sticking to it part that most investors struggle with.

Markets like we've seen of late create understandable stress and can lead to short-term decisions – this New York Times [article](#) from May talks about the cost to investors of acting impulsively.

At the risk of repeating a timeworn cliché, our experience bears out the view espoused by Graham and Buffett that the only way to invest successfully over time is to maintain discipline and a long-term focus – to have the right plan and then to stick to it.

The three charts on the next page speak to this, showing returns among large-cap US stocks from 1926 to 2009 after inflation is taken out.

Since 1926, US stocks have had average gains of over 9% before inflation and more than 6% after inflation.

The first chart shows returns over one-year periods – and truly is a roller coaster. If this was what investing over time entailed, few would have the stomach for this.

The next chart shows returns over three years – showing less volatility but still more than many investors would be comfortable with.



And the third chart shows returns over 10-year periods – the longer you own stocks, the more you avoid the extremes on both the high side and the low and thus end up with an experience that most investors can live with.

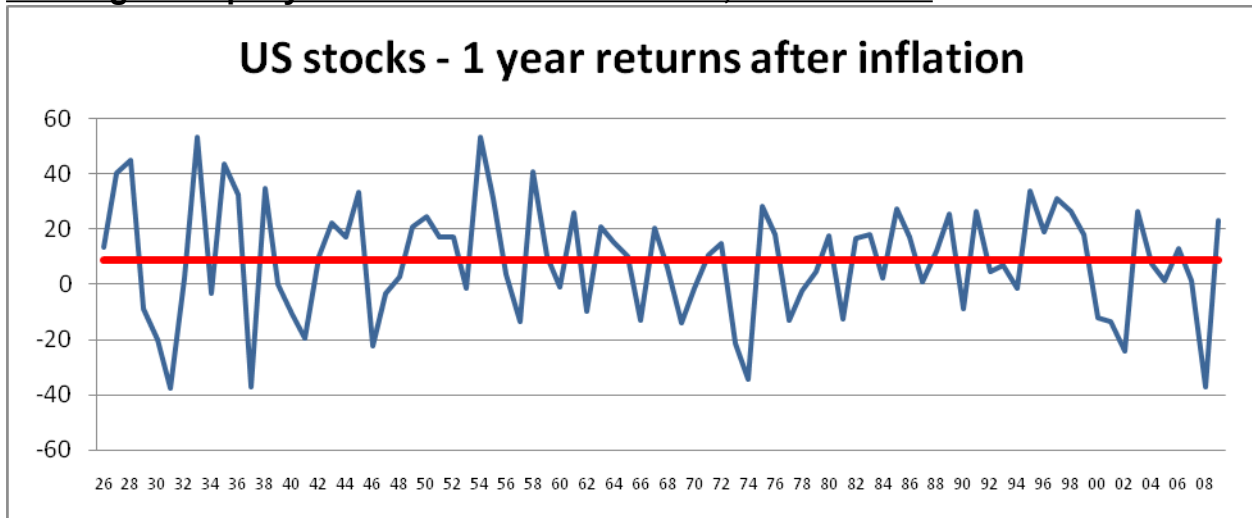
Hard as it can be at times – and at the occasional loss of a client who disagrees - I've found the only approach to investing that works over time is to keep that long-term view, modifying portfolios as circumstances warrant but never losing sight of the fact that long term goals demand long term thinking.

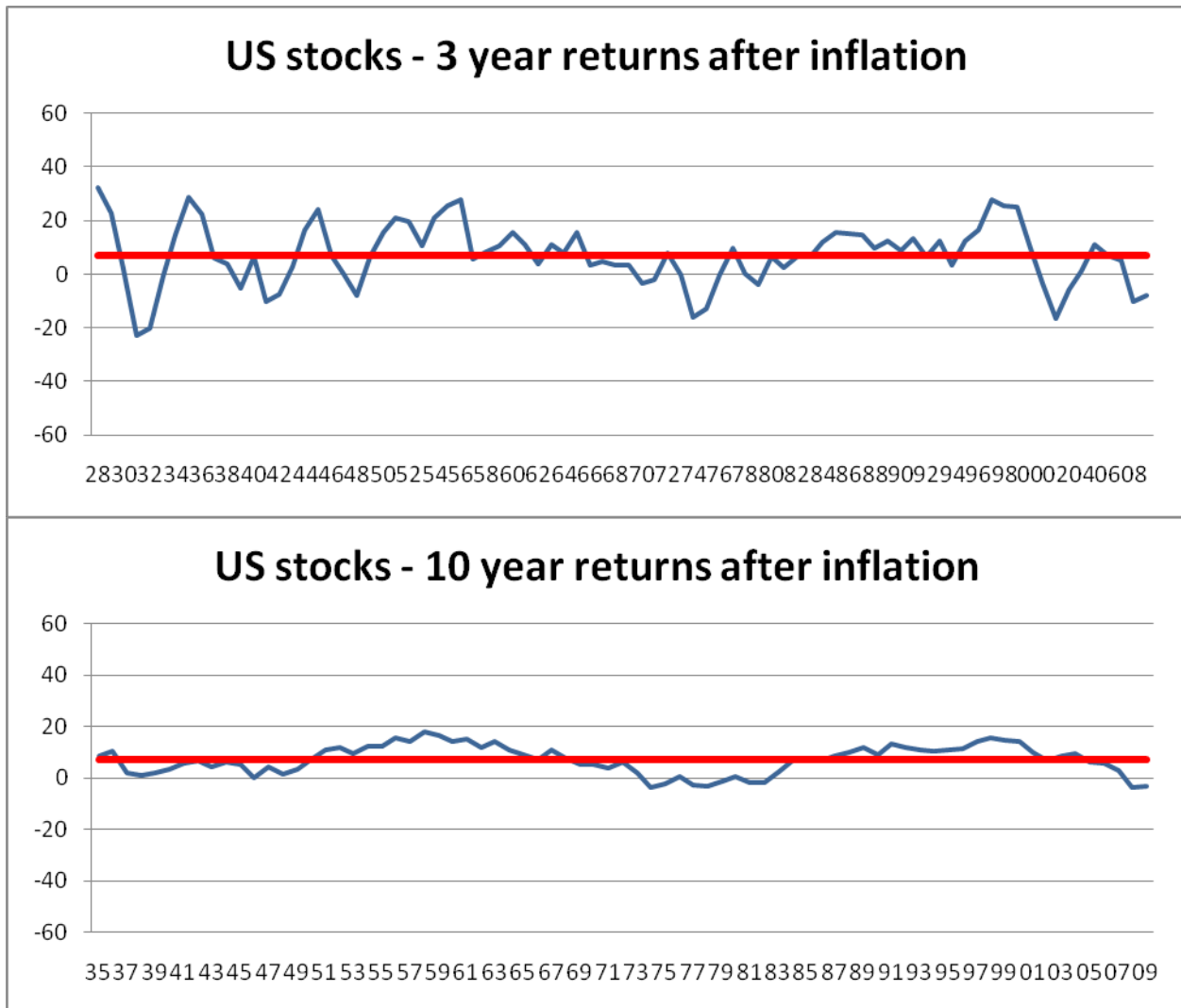
In closing, let me reiterate my appreciation for the continuing opportunity to work together – as always, I welcome your calls and questions and would be happy to talk at any time.

Name of Advisor

P.S. If you're interested, you can read Benjamin Graham's 1963 talk [here](#):

US Large Company stock returns after inflation, 1926 to 2009





Source: Ibbotson SBBI Large Company Stock index, Morningstar Encorr database
Average = Red Line

Dan Richards conducts programs to help advisors gain and retain clients and is an award winning faculty member in the MBA program at the University of Toronto. To see more of his written and video commentaries and to reach him, go to www.clientinsights.ca.

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