Letters to the Editor
April 14, 2009

We have two letters to the Editor. The second letter begins on page two.

The following letter is in response to our article The Building Blocks of the Next Bull Market, which appeared last week.

Dear Editor,

Regarding your commentary on the three legs of the next bull market, it seems you may have overlooked a leg or two: trust and confidence. Weren't those the building blocks of the last bull market?

Our family has been in the retail investment business for 48 years. What this nation's brokerage firms, banks and government have done to investors is nothing short of criminal, and since I have seen nothing from the offending parties which would lead me to believe events such as these can never happen again, I see no reason to advise clients to have trust and confidence again.

If investors had access to real alternative investments, not just those engineered for mass distribution, they would never return to "the circus".

I'll admit I haven't seen too many five-legged stools but, until I see one, I'm staying out of this market.

Mickey J. Smith
Managing Partner
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P.S. Your publication has risen to the top of my reading list. Keep up the good work.

The following is in response to Ken Solow's letter to the editor regarding Clark Blackman's article Glass Houses? An Open Letter to Bob Veres.

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Dear Editor,

I appreciate the time taken by Mr. Solow to raise some interesting points regarding my positions on long term strategic allocation. For starters, I believe Mr. Solow has read much into my letter to Bob Veres that really wasn’t there. He apparently believes I was disparaging all active approaches to money management, particularly those seeking out value in the marketplace and attempting to add alpha to portfolios through exploiting inefficiencies.

That certainly was not my intent. With all due respect, I believe he missed the main point entirely, which was to challenge the thinking that advisers who typically follow a strategic allocation strategy deserve kudos as “more sophisticated” when they jumped out of the market in the heat of battle back in September and October of 2008. It was this position that Bob Veres was leaning toward in his article, Casting No Stones, which made me pause.

Be that as it may, Mr. Solow raised a number of points that need to be addressed. Let me start by clarifying a few definitional items. I have a certain pet peeve about how we in this industry tend to co-opt words and take terms meaning one thing and apply them to another. This is more than just an issue of meaningless semantics. It is imperative that we maintain the integrity of terms so that we all are on the same page and know specifically what we mean when we use a word. This way we can communicate most effectively.

Let me define a few things at the outset. First, maintaining a long term strategic allocation is not a “buy and hold” strategy. A buy and hold strategy, for as long as I have been around, refers to picking securities (stocks, bonds, what have you), and sitting on them until you die, or the company goes bankrupt, or the bond comes due. I do not believe it has a place in any discussion regarding long term strategic investing versus tactical/market timing investing.

Second, the “efficient markets theory,” as originally posited, deals with the flow of information and its effect on the price of securities. It is not a proposition “based on the principles that the economy is not subject to structural change,” as Mr. Solow says. And I don’t believe that the theory is based on the premise that investors have “perfect economic foresight.” My stance on market efficiency is as yet unstated; but regardless of my position on efficient markets, whether I believe the economy can be “foreseen” is an entirely different issue. I believe, as do most long term strategic advisers, that no one has perfect economic foresight. That seems to be the realm of the tactical allocator/market timer - someone more in line with Mr. Solow’s thinking.

And third, “active management” is not synonymous with “market timing.” One can be an ardent believer in active management and still be adamantly against market timing. Active management refers to the process by which one invests in specific securities.
Do you pay for analysis and acumen to discover underpriced securities, or do you simply invest “in the market” ala index funds and ETFs? “Active management” is a way to categorize managers or funds. It has nothing to do with the issue at hand (strategic vs. tactical investing). Tactical allocation is a market timing strategy that can be implemented using active or passive managers or funds. Mr. Solow’s claim that I attack “active management” is patently false. Nowhere in my article did I address active management as the term is generally applied. Let’s save that for another time.

Regarding Mr. Solow’s specific issues with my position, he opens by stating that it doesn’t take much time, energy, research or expertise to remain committed to a strategic allocation strategy. On the contrary, I have a number of very knowledgeable and well-informed clients who require logical, rational reasons and research for why they should not react to the fear of the marketplace (as many of their otherwise intelligent friends have). Without this input, many of my clients would have requested a more tactical approach or they would simply have left.

Bob Veres and I disagree on this very issue. To suggest it is more sophisticated, analytical and smart to move money around in anticipation of future events following a severe market downturn is quite frankly irritating to me and other advisers who bring an enormous amount of experience, knowledge, expertise and ability to the table. Clients are reacting to fear in these scenarios. We believe that research is better applied to ways to improve long term client portfolio performance than to try to predict the unpredictable (one way to do this is to stop moving money around for emotional reasons).

Mr. Solow accuses me of ignoring the fact that a strategic allocation decision is a gamble, as is market timing. Let me clarify: we know that whatever one decides to do with money, a gamble is involved. Investing is a gamble. Saving is a gamble. Spending is a gamble. They all have an element of risk because we can’t know the future. But strategically allocating a portfolio is the least risky of all the “gambles.” It avoids the cost of moving money around and the risks of significantly overweighting an asset class (say cash, or gold, or an underground bunker), only to be wrong in having made that bet.

If the answer is “tactical allocators don’t have to make big bets - we can just tweak a little here and gunch a little there,” then I’m not sure you are doing anything other than placating clients. And if that is what it takes to keep your clients happy, then more power to you. I’m not against that. Sometimes it works to their benefit, sometimes not. Just don’t berate the adviser who is willing and able to honestly tell their clients they don’t know what the market is going to do next week or next year.

Mr. Solow’s argument regarding risk premiums and valuation revolves around his contention that tactical strategies are just simply better than strategic strategies. Since the purpose of my article was not to argue for one over the other (as stated at the
beginning of this letter), I'll not engage in that battle here. However, I would argue that risk premiums are not going away, in spite of Mr. Solow's belief that they are. And as far as “valuations” are concerned, one man's trash is another man’s treasure… a very subjective thing.

Mr. Solow suggests that I would label an adviser who executes a transaction in search of good value a “market timer, an untouchable who gambles with client money.” I'm not sure what I said to deserve that accusation. If, within the constraints of a strategic portfolio allocation, a transaction can add value, then I am all for it. Just do it within the confines of the adopted strategy. Moving out of an asset class because it has fallen out of favor for the time being is hardly what I call a simple “transaction” in the portfolio. It is a market timing decision and should be labeled as such.

Mr. Solow goes on to say that “making an accurate forward looking forecast will require a different level of expertise about the macro economy and market cycles.” A different level than what? And by whom? In my article I quoted no less an economic authority than John Maynard Keynes as saying “the only function of economic forecasting is to make astrology look respectable.” If Mr. Keynes didn't believe it could be done respectfully, then why should I believe that it can be done by someone of lesser stature? I don’t intend any disrespect to Mr. Solow in any way – few reach the eminence of Professor Keynes. My 29 years of experience tells me to side with Keynes!

The unexpected event will always rule the day. Call it a Black Swan, or call it the Reality of Life. There is no knowing the unknown. Let's stop pretending otherwise. Clients really, really want to believe that there is a way to avoid the downside of investing. Trying to convince them it is simply a matter of crunching enough numbers and “all will be well” is not something I am comfortable doing. Telling clients that the future is somehow predictable if one simply does enough research is, to be kind, a bit of a stretch.

When forecasts are wrong, there is always a very good reason - “well, it was this thing, and who could have known that, or it was that thing and really, how could one be expected to have accounted for that?” When you have a built-in excuse for being wrong, and that reason is an unforeseen, unexpected event, then why not just accept that anything is possible.

Mr. Solow says that “clients can ‘buy and hold’ [he actually means ‘stick to an agreed to strategic policy’], with the virtual certainty of underperforming expected historical average returns [I have no idea where this assertion comes from] desperately hoping that better days are just around the corner for their clients. Or they can choose to ‘actively manage’ [he means ‘tactically allocate or market time’] with a good probability of outperforming the vast majority of advisers who think that valuation either doesn’t matter, or good values don’t exist.”
How can Mr. Solow be so certain market timing offers a “good probability” of outperforming strategic investors? A “good probability” is vague, but I assume it means materially more than 50%. Is it 70%? 80%? I’d like to see the research supporting that contention.

I would rather follow a strategy agreed to in calmer times and “hold on desperately hoping for better days” (as Mr. Solow put it), than change strategy in a down market, and desperately hold on hoping for worse days! When people decide to make dramatic changes based on the expectation that things will only get worse, then of course they will always hope they are proven right. When someone dumps stocks and buys gold for example, what’s their worst case scenario? That stocks rebound, the economy recovers and gold goes back to $500 on ounce! If they sell everything and go to cash, they will hope that the market continues to fall and interest rates spike up, further damaging the economy and increasing their money market interest rates. Is it worth enduring this misfortune to be proven right and to benefit from all the bad news? Who could blame them? So, if I’m going to be caught “desperately hoping” for something, I can only pray it is for better days!

It appears Mr. Solow believes that only he and his ilk are capable of “studying market values, real estate prices, consumer spending data, the government’s Public-Private Investment Program and other data.” As a strategic adviser, I do that too, but I understand that historical data is not like reading tea leaves, and know it will not provide clear answers to what tomorrow has in store.

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