Thompson, Siegel & Walmsley, Inc.
INVESTMENT COUNSEL

Eyes Wide Shut

Stock returns are not guaranteed. There is probably no more obvious statement about investing to make, especially given the past four years. However, the message behind this absolute truth is one that many lose sight of despite the painful reminders of recent experiences. What we observe in the current environment prompts us to highlight independent thought as one of our core beliefs and a critical component to long-term investment success.

"When everybody thinks alike, everyone is likely to be wrong." - Humphrey B. Neill

In his classic book written decades ago, The Art of Contrary Thinking, Humphrey B. Neill details the danger of blindly following the investing crowd. Examples of financial disasters punctuated with the overwhelming opinion of the majority have been well chronicled and extend back literally centuries in time. If financial market historians have documented these events so well, why then do so many investors today make the same mistakes as those in the past?

The answer to the question lies in part with the opening sentence of this essay. The uncertainty of return inherent in stocks elicits predictable behavioral responses from investors. Unfortunately, these reactions often work against investors and lower the odds of success. For example, one tendency in human nature is how we deal with the uncertainty of an outcome. The more unsure we are of an outcome, the more we look to validate our expectations with the opinion of others. This need for validation becomes more powerful the wider the potential results and the more significant the consequences of our decisions.

"Don't gamble; take all your savings and buy some good stock and hold it till it goes up, then sell it. If it don't go up, don't buy it." - Will Rogers

Will Rogers frequently commented on the stock market. His quote above is a humorous piece of advice on how easy investing in stocks would be if we could predict the future. While investors would like their decision immediately substantiated in the market it is unrealistic to expect it to happen. Even with this acknowledgment, there is a natural disappointment when a stock continues to decline after purchase or rises after it is sold. The more a stock moves contrary to the initial expectation, the more an investor will question his or her own judgment, rather than the judgment of the market. It is this central tendency to believe the majority opinion is always right that causes many investors to place far too high a weight on the near term movement of the market.

"Gentlemen prefer bonds." - Andrew Mellon

Bond investors are not immune to the forces that affect stock investors. The return on bonds of course is more predictable than stocks because of the defined maturity date on most debt instruments. What undermines the patience of bond investors though, is the volatility of interest rates prior to maturity and the opportunity to make or lose money in bonds during intervening periods. The traditional buy and hold mentality is certainly no longer evident among bond mutual fund managers. A well known mutual fund tracking organization recently measured the average portfolio turnover rate for the more than 2,600 taxable bond mutual funds to be 172%. The turnover rate was in fact much higher than the 105% measured among domestic stock funds over the same period.

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"Two roads diverged in a wood, and I-
I took the one less traveled by,
And that has made all the difference." - Robert Frost

The famous quote from Robert Frost is a valuable sentiment for investors to keep in mind. The most well-worn path in investing tends to be where the most money is flowing at the moment. The greater the flow, the more convincing are the arguments against doing anything else but investing with the majority. History shows however, that following such a tactic can lead to very poor investment results. Investors poured a record $331 billion into stock mutual funds over a 12 month period ended September 2000. During this same period, bond funds had record net redemptions of $67 billion. Market returns over the following 12 month period caused many investors to regret their decision as the stock market fell 30% while the bond market produced a positive return of 12%. But that was then and this is now, right? Wrong. Over the 12 month period ended March of this year stock mutual funds experienced a record $93 billion in net withdrawals while in the 12 months ended April 2003, bond funds enjoyed record inflows of $159 billion. Judging by the relative returns in stocks and bonds since early Spring it looks once again like the road less traveled was the right one to take.

Eyes Wide Shut - Stanley Kubrick film (1999)

Stanley Kubrick's last film before his death was about the relationship between a doctor and his wife played by real life husband and wife (at the time) Tom Cruise and Nicole Kidman. A movie about two characters that struggle with commitment and temptation would hardly appear to be a useful analogy to the financial markets. However, investors are continually faced with the trade-off between staying committed to a strategy based on long-term financial plans and the persuasive pull of big short-term payoffs in the market.

The downside risk in abandoning long term goals in favor of quick money returns would seem excruciatingly apparent following this most recent equity bear market. But the evidence suggests that memories are surprisingly short for some investors. Two of the more successful strategies this year have been to buy stocks that began the year priced under $5 per share or companies that were losing money. We think investing in near-worthless stocks or in unprofitable companies are not winning strategies in the long run. Yet it would appear that for now, just like the late 1990's, many investors are bidding up the prices of low quality companies to unsustainably high valuations.

"You can observe a lot just by watching." – Yogi Berra

The financial markets today are in far better shape and with far saner valuations than the speculative environment of the late 1990's. Sentiment can change quickly though and extremes in market sentiment for individual securities can and will always exist regardless of the level of the indexes. Investors who are not mindful of how market expectations can be taken to extremes will miss the wisdom behind Yogi's quote.

TS&W has followed the discipline of value investing for over 30 years. Implicit in this philosophy is our belief in the importance of independent thought and the willingness to act contrary to market opinion when sentiment appears most one-sided. This principle is not always easy to hold onto but a firm grasp is vital if success is to be achieved.

We hope this viewpoint is a useful insight into TS&W and one of the elements of successful investing.♦

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