the EDUCATED INVESTOR

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FOCUS Asset Management Company

The Best Choice of All

Life is full of choices: Here or there, yes or no, take it or leave it. With the many selections you face daily, it may seem counterintuitive (although hopefully a welcome relief to your otherwise busy life) that trying to pick individual stocks to build or maintain a prudent investment portfolio is one choice best not made to begin with.

We aren't alone in our opinion on the matter. For example, consider the following quote:

> Over the [past] 35 years, American business has delivered terrific results. It should therefore have been easy for investors to earn juicy returns: All they had to do was piggyback Corporate America in a diversified, low-expense way. An index fund that they never touched would have done the job. Instead many investors have had experiences ranging from mediocre to disastrous … Investors should remember that excitement and expenses are their enemies.
>
> — Warren Buffett
> Berkshire Hathaway 2004 Annual Report

The rest of this issue of *The Educated Investor* explores how our advice and Warren Buffett's observation relate. Forego attempts to pick winning stocks; instead, invest in Buffett's recommended "diversified, low-expense way." Diversification is a prudent portfolio management technique, designed to reduce risk exposure; this is achieved by mixing a variety of investments that have different risk/return characteristics. In other words, avoid putting too many of your eggs in one basket. The following articles help explain why:

- **Passing up on Picking Stocks —** Stock-picking adds expense and should not be expected to generate returns above market average over time.
- **The Dow of Investing —** Trying to limit your stock picks to "safe" holdings (such as those found within the Dow Jones Industrial Average) is still more akin to speculation than to building a prudent, long-term investment approach.
- **Sizing up Your Investments —** Great company earnings don't necessarily translate to great company stock returns for the investor.

So, kick back with a hot cup of coffee and enjoy the reading. Would you like that with cream or sugar?

Passing up on Picking Stocks

Late last year, Merck announced that it was removing Vioxx from the market because clinical trials found that it increased risk for heart attacks and strokes. The news was bad for the healthcare industry as well as for Merck investors.

Merck's shareholders saw the stock plummet from roughly $45 to $28 per share during the two-month period following the announcement. As of this writing, its price has recovered slightly to about $32 per share, remaining 30 percent below its closing price on the day before the bad news was delivered.

Continued on Page 2

Passing up on Picking Stocks (cont.)

Of course a similar calamity could have befallen any company's product or service. Merck's example is among the more recent and vivid illustrations of why owning individual stocks is much riskier than owning diversified portfolios of stocks (preferably held within passively managed, low-cost mutual funds).

Events that impact stock performance can be broadly grouped into two categories:

1. Events that affect a single company (or industry/sector)
2. Events that affect all companies

Any company's stock price can be affected by either type of event. The type that affects all companies cannot be eliminated through diversification (i.e., by dividing your investments among a variety of holdings). Thus the academic data indicates that investors who accept the general risk of owning stocks within their portfolios can expect to be rewarded with an "equity risk" premium over time. If there were no premium over risk-free securities (Treasury bills), nobody would be willing to buy stocks and take on the risk.

Single-company risk should be viewed quite differently. Every company has exposure to individual risks that can easily be removed via diversification; classical finance theory says that diversifiable risk should go unrewarded. This means that investors should diversify and rid themselves of company-specific risk such as the kind that hit Merck investors last fall. Why take a risk that does not carry commensurate expected reward?

Even though the logic seems intuitive, many investors fail to properly diversify — or they fail to remain properly diversified even if they begin that way. There are more reasons why, than there is room in our newsletter, but here are three important factors:

Overconfidence

We all need confidence. In certain aspects of life, a touch of overconfidence can even be useful. However, overconfidence and investing don't mix well. Overconfident investors who believe they will be smarter than the rest of the market tend to hold concentrated, undiversified portfolios, believing they can succeed where the majority has failed.

Anchoring

Anchoring is an investor's tendency to fixate on an old stock or fund price. For example, imagine that a stock/fund is trading at $50 per share when two weeks ago it was trading at $54. An investor may anchor on the old price of $54 because he or she assumes that is what the holding is worth (or at least wishes it were). He or she may be reluctant to sell, even if it is important to do so to remain diversified, deciding instead to try waiting until the holding returns to its old, higher price.

Because there is no way to know whether any given stock price will recover or continue to plummet, the decision to forego diversification while remaining fixated on a particular share value is closer to speculation than investment.

Loss Aversion

Nobody enjoys taking losses on their investments. But some more than others treat it as the equivalent of saying, "I was wrong." This can leave them reluctant to take the loss, even when they should be doing so to maintain an effectively diversified portfolio.

A decision *not* to take a loss is essentially a decision *to* purchase the stock at current price. (From a portfolio construction viewpoint, continuing to hold each day is the same as if you had purchased that day.) Described this way, most investors agree they would not repurchase the stock at its current price, which means it is a candidate for sale if the overall portfolio allocation warrants. In addition, there can be important tax benefits to taking losses within taxable accounts that should be considered an important way to manage overall costs within a prudent investment approach.

Conclusion

By trying to pick individual stocks, you face a double-whammy: the risk that your holdings might become the next victims of random bad news, plus the knowledge that academic analysis indicates this type of risk is expected to go unrewarded.

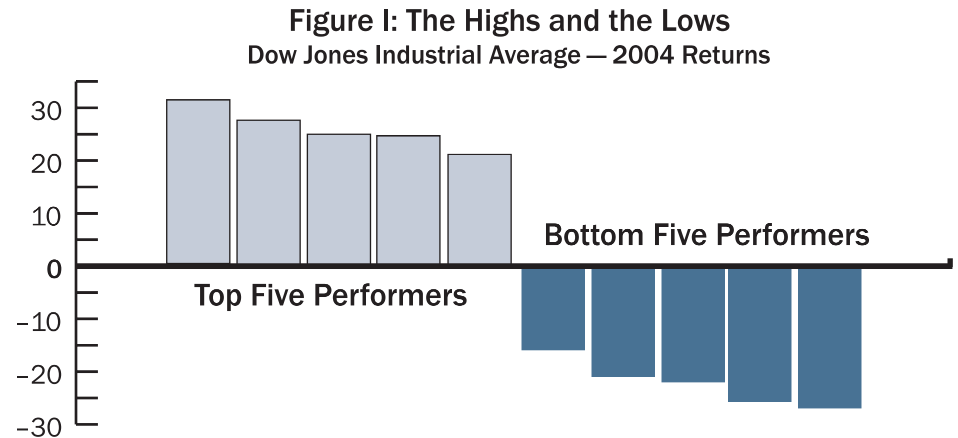
On the other hand, owning stocks in general *is* expected to deliver a risk-based premium over time, as the reward shared by all stock holders for accepting marketwide risk. The way to capture this equity risk premium is by taking advantage of our prescription for effective diversification within passively managed, low-cost mutual funds.

In addition, recognizing and avoiding the behavioral traits described above — overconfidence, anchoring and loss aversion — helps you remain properly diversified over time, even as our human nature tempts us to make investment decisions that may be damaging to our financial health.

The Dow of Investing

Sometimes investors try to build a "safe" equity portfolio by picking stocks included in a widely recognized index of large, "blue chip" companies, such as the Dow Jones Industrial Average (Dow). They hope that such selectivity will allow them to avoid losers and select winners. In reality, this technique is subject to at least two inherent weaknesses.

Figure I: The Highs and the Lows
Dow Jones Industrial Average — 2004 Returns



How now, Dow? Every year and index is different, but the Dow's 2004 performances show relatively typical variance among its individual holdings. Its five **best** performers returned between 21 and 31 percent; its five **worst** returned between –16 and –28 percent.

First, *any* individual stock picking is subject to the dangers of individual stock risk described in our previous article. Second, in an ironic twist, "good" companies such as those the Dow selects, actually are expected to deliver lower returns over time than their riskier counterparts (examined in more detail in "Sizing up Your Investments").

Like other market indices, the Dow and its components (representing large-cap growth stocks) experience up and down years. As fate would have it, odds would have been in favor of a stock-picking approach within the Dow in 2004. Sixty percent — 18 of the 30 Dow holdings — happened to perform better than the average 5.3 percent return experienced by the overall index.

At a gaming table, 3:2 odds (60 percent) might be considered an attractive bet. Therein lies the difference between speculation and investment. By trying to actively pick specific stocks, you may get lucky — even very lucky. But you also may lose out, a lot or a little. Not a good way to comfortably plan your financial future. (Also, it is important to note that these odds are for just one index in just one year; we would caution that overall stock-picking odds are just as likely, or more, to be stacked against the investor).

Instead, the more prudent approach is to build a portfolio using passively managed mutual funds to capture the broad holdings of various asset classes in a low-cost, tax-efficient manner. Through such carefully planned construction, you can let the markets work for you, providing expected delivery of an overall average return that reflects your unique investment objectives.

Moreover, in some respects, 2004 was typical, considering the wide variance in individual performance among the 30 Dow holdings. The five **best** performers returned between 21 and 31 percent, while the five **worst** performers delivered negative returns of between –16 and –28 percent (Figure I).

Because the variance is frequently this wide or wider, years such as 2004 best serve as lessons on why it remains important, year after year, to maintain a cost-effective, disciplined outlook based on expected long-term results. The only way we can know which stocks will outshine others in a single year is in retrospect. Thus it is best to avoid participating in the active game of trying to predict them (and incurring high transaction costs in the process).

Can You Pick the Dow's 2004 Winners and Losers?

To illustrate how difficult it can be to pick "winning" stocks and avoid "losing" ones, let's play a game. The following is an alphabetical listing of the 30 stocks comprising the Dow in 2004. See if you can identify that year's top five and bottom five performers, depicted in Figure I. Turn to page 4 for the answers.

3M Company	Boeing	ExxonMobil	Honeywell	McDonald's	SBC Communications
Alcoa	Caterpillar	General Electric	IBM	Merck	United Technologies
Altria Group	Citigroup	General Motors	Intel	Microsoft	Verizon
American Express	Coca-Cola	Hewlett-Packard	Johnson & Johnson	Pfizer	Wal-Mart
AIG	Dupont	Home Depot	JPMorgan Chase	Procter & Gamble	Walt Disney

Sizing up Your Investments

True or false: A good approach to investing is to limit yourself to stocks of companies that have grown large and enjoy exceptional earnings. While it feels as if the answer should be "true," the truth is, it is "false."

A common investor misperception is that you can seek great returns by investing exclusively in great companies. The misperception arises when investors mistake the *earnings* generated by a company with the *returns* earned by its shareholders.

For investors to purchase stocks of firms that are riskier because of their size (small-cap stocks) or that are experiencing some distress such as lower earnings ("value" stocks), they must expect to be rewarded with higher returns on their capital.

Consider two similar companies, Wal-Mart and JC Penney. Most would agree that Wal-Mart is a more successful company and a safer investment. It has far higher current earnings, and is expected to produce much faster growth of future earnings. If you could buy either at the same market capitalization, say $20 billion, your choice would be Wal-Mart.

But if the purchasing opportunity were identical for either, investors would soon recognize it. They would begin buying shares of Wal-Mart (driving its price up), and selling shares of JC Penney (driving its price down). In effect, investors would lower the risk premium they demand on Wal-Mart and raise it on JC Penney.

Now imagine that Wal-Mart's share price rises relative to JC Penney — bringing the companies' values to, say, $100 billion for Wal-Mart and $10 billion for JC Penney — until the two have the same *expected* (not guaranteed) future rate of return of 10 percent. Since Wal-Mart is still perceived to be the less-risky company, investors would still prefer it over JC Penney. This pattern would continue until JC Penney's price were "discounted" enough for investors to consider it, even with its riskiness, an equivalent deal compared to Wal-Mart — for example, when Wal-Mart's value reached $200 billion and JC Penney's value was reduced to $5 billion.

Thus, the difference in stock price between Wal-Mart and JC Penney is directly related to the difference in perceived investment risk. Sometimes the price differential (risk premium) has to be very large to entice investors to accept the risk of owning the lower-quality company.

Investors demand to be "paid" in the form of higher expected premiums for accepting the risk entailed in purchasing stocks of smaller or less successful firms. That is why these stocks are expected (although not guaranteed) to deliver greater returns over time. And, in fact, historical returns have met this expectation. Small-cap and value stocks have outperformed their large-cap and growth stock counterparts over time.

Answers for the Dow's 2004 Winners and Losers

How many of the Dow's 2004 winners and losers were you able to identify on page 3? It's a challenge even in retrospect, let alone predicting them before the year unfolds!

Top Five

McDonald's (31 percent)
ExxonMobil (28 percent)
Johnson & Johnson (25 percent)
Boeing (25 percent)
Home Depot (21 percent)

Bottom Five

Merck (–28 percent)
Intel (–27 percent)
Pfizer (–22 percent)
General Motors (–21 percent)
Coca-Cola (–16 percent)

FOCUS

Our Basic Tenets

Our objective is to design portfolios using passive asset class funds that maximize investors' returns within their tolerance for risk. Here is what sets us apart:

- ▲ Fee-only investment management
- ▲ A disciplined investment strategy
- ▲ Access to institutional no-load passive asset class funds
- ▲ Fixed income expertise
- ▲ An academic Nobel Prize-winning investment approach
- ▲ Continued access to academic research
- ▲ A tax-efficient focus, with valuable tax and estate-planning ideas
- ▲ Risk tolerance assessment
- ▲ Periodic portfolio rebalancing
- ▲ Regular communications and state-of-the-art reporting
- ▲ **MOST IMPORTANT ... A TRUSTED ADVISOR RELATIONSHIP**

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