Letter From The Portfolio Managers

August 4, 2006

The Best Time To Invest

Eric M. Kobren

We often hear the question, "when is the best time to invest in the stock market?"

From a financial planning perspective, the answer is when you have the ability to do so. That is, after you have covered the basics, such as enough insurance, a sufficient cash reserve, and proper debt management. Only once those needs have been taken care of do you have the capacity to take on market risk.

Rusty Vanneman

Okay, we are going to make the bold assumption that all of you meet that condition or you wouldn't be receiving this letter. Now when is the best time to deploy your money?

Well, from a statistical standpoint, the answer is simple: immediately.

Since the stock market generates positive returns over time (in other words, while there are bear markets to contend with, the long-term trend is up), each day in the stock market has an expected absolute positive return, and that expected return is superior to cash savings. Therefore, the sooner your money can start compounding, the better.

That, of course, assumes we have no idea of whether the current market conditions are favorable or unfavorable for such an investment. For example, if we knew the market was about to go down for the next six months — it would obviously pay to wait in cash, right?

Well, not so fast. We would have to know that it was going to go down for EXACTLY six months -- not a couple of weeks (or perhaps even a few days) less!

Why?

Because gains and losses in the market don't come in nice smooth increments each day -- but in big gulps. If you have been with us for a while, you have probably heard us mention the following fact, but it bears repeating: Over the past 20 years (1986-2005) if you missed just the 10 best days in the market (10 out of over 5,000 trading days!), you would have given up a staggering 42% of the market's total 20-year return.

And just when do those big up days occur -- yes, you guessed it, quite often right around market bottoms. For example, three of those top-10 days came within nine days of each other beginning just 3 days after "Black Monday" in October 1987. The result is that investors waiting in cash for the market to "get better" will almost assuredly miss those big up moves.

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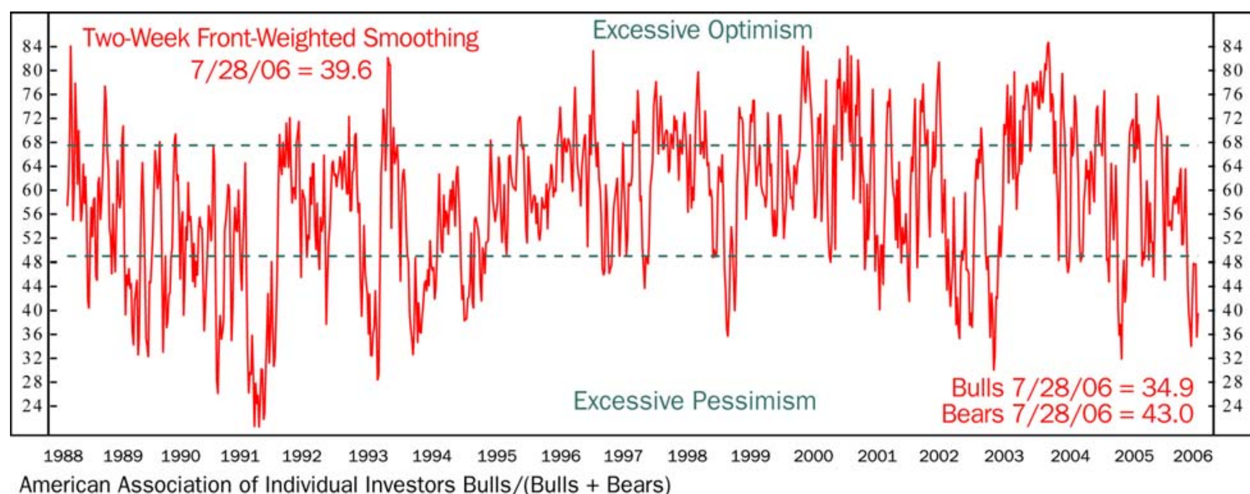
Now, we do not pretend to be able to accurately predict short-term moves in the market, so our advice on when to invest generally follows the statistical answer of "immediately." If a client is too uncomfortable with that we may "dollar cost" average them in over several months — understanding that barring any special knowledge of the market ahead, the result is statistically likely to be suboptimal to investing it all at once.

But we can offer you some guidance about how to assess whether or not current market conditions are "favorable" for investment. In short, the best time to invest is when everyone else would think you were nuts for doing so. As Sir John Templeton, the legendary money manager and founder of the Templeton Funds, said: "Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria. The time of maximum pessimism is the best time to buy and the time of maximum optimism is the best time to sell."

There are many recent examples of this aphorism at work. One direct measure of investor sentiment is mutual fund flows. In July of 2002 stock mutual funds experienced a record net outflow. The market rallied in late July (including two more of the best 10 days of the past 20 years) and while there were more down days to come, October of that year marked the beginning of a powerful bull move. And it goes both ways. The all-time record inflow into stock mutual funds occurred in February 2000 — immediately before the S&P 500 lost half of its value and the Nasdaq (a proxy for tech stocks) lost three quarters of its value.

Where are we today? Well, this past June was the worst month for stock mutual fund outflows (we haven't seen the July data yet) since February 2003. After February of 2003, the market (S&P 500) gained 21% over the next six months.

Another measure of investor sentiment that we have discussed before is the American Association of Individual Investors sentiment poll. As tracked by Ned Davis Research, the percentage of AAII members who say they are bullish (bulls/bulls+bears) was in the extreme pessimistic area at the end of this July.



American Association of Individual Investors Bulls/(Bulls + Bears)

Source: Ned Davis Research, Inc.

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S&P 500 Gain per year when: (7/31/1986-7/28/2006)	
AAII Survey is:	Gain/Year
Above 67.5	-1.6%
Between 49 and 57.5	6.5%
49 and below	19.5%

Source: Ned Davis Research, Inc.

According to Davis, since 1987, when the individual investors are extremely pessimistic (less than 49% bulls), the market generates future 12-month returns of nearly 20%. When sentiment is overwhelmingly positive (more than 67.5% bulls), the market's future returns are actually negative over the next 12 months. When sentiment is neither at a bullish or bearish extreme, then returns are positive, but below average. In other words, the only environment (all else being equal) that generates above-average stock market returns are when investors are overwhelmingly bearish.

Both of these sentiment indicators suggest better market times ahead.

But What About The Fed?

The Federal Reserve next meets on August 8. The question regarding whether the Fed will raise short-term rates yet again has been one of the leading reasons cited why market volatility has increased in recent months. Much ink has been spilled attempting to guess what the Fed will do, and say, on August 8.

Why do we pay so much attention to the Fed? For starters, there are news cycles that need to be fed. Second, the Fed is often conveniently used as a scapegoat when trying to explain macroeconomic behavior. For instance, it would be easier to blame the Fed for a recession because they "excessively" raised interest rates, instead of attempting to explain the reality that the economy moves due to the complex interplay of various economic variables and conditions.

To be fair though, what the Fed is worried about is, in fact, what we all should be worried about, not only as investors, but as individuals in a global economy: stable prices and sustainable economic growth. The future level and trend of prices in the economy is indeed a critical factor in future stock, bond, cash, commodity, and other asset class returns. If we see higher inflation, that will eventually be reflected in higher interest rates and lower stock valuations (all else being equal). Low inflation meanwhile, which we have enjoyed for years, should mean continued low interest rates and higher stock market valuations (all else being equal).

While we don't know, of course, what the economy will exactly do in the coming years, we do have a perspective based on research and experience. And to us, the current inflation outlook remains mixed. On one hand, there are short-term factors (slowing economic growth, softening real estate prices) and long-term factors (globalization, productivity gains, demographic trends) suggesting that inflation should remain contained in the near future.

On the other hand, a compelling argument can be made that inflation will return. Certainly, the long-term supply/demand picture for commodities, particularly energy, remains worrisome. Perhaps as significant, however, are the enormous future liabilities concentrated in social

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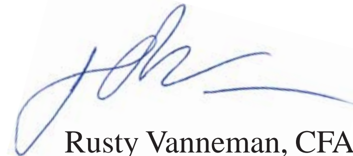
security and healthcare that the government will need to pay. Taxes could be raised and government spending in other areas could be cut, but another response could be to inflate their way out of those obligations.

Currently, our portfolios are built with this mixed outlook in mind. We have some funds that should do better in a lower inflation environment and we have funds that should perform better in an inflationary environment. We believe that a properly diversified portfolio should own a variety of securities that perform differently in various market conditions.

In sum, the news headlines this summer have been heavy with negative news ranging from the Middle East conflict to raging summer heat. Falling house and stock prices haven't helped matters much either. Nonetheless, if history is any guide, current sentiment conditions suggest this is a better time to buy than to sell - regardless of what the Fed does August 8th.

Sincerely,

Eric M. Kobren
President
Portfolio Manager



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