October *MoneyMinute* – The DOW at a new high, should we do anything?

By Rich Chambers, CFP®

Long-term investment success

With the Dow Jones Industrial Average surpassing the 12,000 mark, it seems a perfect time to remind readers that the road to long-term investment success has always been filled with many short-term potholes. Consider that the Dow has hit a record high even though recently North Korea conducted a nuclear test, a small plane carrying New York Yankee's pitcher Cory Lidle and his flight instructor crashed into a Manhattan skyscraper, the options backdating scandal snared several additional high-profile executives and the September business-conditions index published by the Philadelphia branch of the Federal Reserve showed that manufacturing activity in that region was contracting for the first time in three years.

There is always some bad news – somewhere

And we can't forget that just a few months ago police in the United Kingdom took 21 people into custody over an alleged plot to blow up several trans-Atlantic flights with explosives smuggled in hand luggage or that three months ago hostilities broke out between Israel and Hezbollah, sparking fears that other Middle Eastern countries would become involved in the conflict. Stocks have also moved up despite September and October being two of the worst performing months of the year, historically speaking.

Most investors don't even get the average market returns.

While Ibbotson Associates tells us that equities have returned 10% to 12% on average over the past 80 years, we also know that the majority of investors are unable to achieve this level of performance. Why is that? Because they trade far too often, moving in and out of the market in reaction to media headlines, chasing yesterday's stars while dumping tomorrow's potential winners. Don't believe us? *The Wall Street Journal* recently cited research from mutual fund rating agency Morningstar that said that over the past 10 years, owners of diversified U.S. stock funds collected 7.3% a year, less than their fund's average 8.8% published return.[1]

That same article cited a University of Michigan academic study by Ilia Dichev that examined the long-run returns following all capital flows over the entire history of available stock returns and across the United States and many foreign countries. The study found that aggregate dollar-weighted returns are systematically and considerably lower than buy-and-hold returns. The annual return differential is 1.3 percent for the NYSE/AMEX market between 1926 and 2002, 5.3 percent for the more volatile Nasdaq between 1973 and 2002, and an average of 1.5 percent for 19 major stock markets around the world between 1973 and 2004. Mr. Dichev concluded, "The results provide comprehensive evidence that stock investors' actual returns are considerably lower than those from passive holdings and very different from widely published and studied security returns."

Timing the market

Sure, there will always be some who successfully time the market as it certainly would have been nice to have been on the sidelines for the big downturn during 2002 and then fully invested after equities bottomed in October of that year. And we recognize that many will continue to frantically move in and out of stocks after getting signals from price charts while others will put their faith in pundits who play on emotions like fear and greed with predictions that the market will soar over the next three years only to crash sometime after 2010 as baby boomers cash in their stocks to fund their retirements, or that the crash will come six years later when boomers turn 70 and start to withdraw from their 401K and other pension plans.

Buy-and–hold

Conceding that we do not know what the future will hold, we continue to believe that a slow and steady, buy-and-hold-with-periodic-rebalancing strategy produces the best returns over time. After all, such an approach generally yields more undervalued shares to buy when stocks are low and affords greater opportunity to sell over-valued companies when share prices have advanced.

Despite the historical evidence that suggests long-term investing is the way to go, we understand that there will always be scary things to worry about and our faith in equities will constantly be put to the test. Certainly, we can't dismiss every concern and there undoubtedly will be more downturns in our future, but it is helpful to remember advice offered by legendary investor Peter Lynch and Al Frank, my all-time, favorite investor.

Nine recessions AND nine recoveries

Here is what Peter Lynch, the former Portfolio Manager of the Fidelity Magellan Fund said in the wake of the tragic events of September 11, 2001: "Despite nine recessions, three wars, two Presidents shot (one died and one survived), one President resigned, one impeached, and the Cuban Missile Crisis, stocks have been a great place to be. The United States historically has had a perfect record when it comes to rebounding from the most difficult times. With those nine recessions, we've had nine recoveries. Since World War II, corporate earnings are up 63 fold and the stock market is up 71 fold. Corporate profits have grown over 9 percent annually despite the down years."[2]

Free enterprise works

Al Frank's words of wisdom, written on October 1, 2001, were as follows: "I cannot live in fear of the next terrorist attack (if you make yourselves sheep the wolves will eat you) or of the bottom dropping out of the market. My attitude is not a question of being optimistic or indifferent, it is based on history and probability as I see it. There will probably be more terrorist attacks, and although many of them will be thwarted, some will happen. Even so, we will have to adjust and live as normally as possible (albeit a new norm). The stock markets are part of the fabric of our free enterprise system. They will be around and functioning for a long time."[3]

And speaking of September 11, if we somehow had advance knowledge of the terrorist attacks, the natural reaction might have been to liquidate our equity portfolios, but our real-world experience illustrates that unless one's timing was superb this would not have been the right move. Yes, the stock markets did tumble when trading finally resumed on September 17; 2001 however, those short-term losses were overcome and then some by the end of 2001.

[1]The Wall Street Journal October 18, 2006, Coming Up Short page D1.
[2]Peter Lynch Market Commentary, September 20, 2001
[3]Al Frank's The Prudent Speculator, October 1, 2001

The above was excerpted from *The Buckingham Report*, October 19, 2006. John Buckingham is the CEO and chief portfolio manager for Al Frank Asset Management, Inc.

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Rich Chambers, CFP®,
Julie Schatz, CFP®,
Jennifer Cray, CFP®
Investor's Capital Management, LLC Menlo Park
Providing Unbiased Guidance to Financial Success
Member of and NAPFA and the Garrett Planning Network
650-323-4706 info@feesonly.com http://www.feesonly.com

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