

Investing in a Hostile Environment

Note: The following is a paraphrased summary of recent conversations on a timely subject.

CLIENT: Treasury Secretary Timothy Geithner said the U.S. stock market, Treasury bonds and the dollar will crash if the debt ceiling isn't increased. Should we just sell everything?

BARRY HYMAN: Absolutely not.

CLIENT: Why not?

BH: Selling out of fear is contrary to what investing is about. Investing is about building thoughtful portfolios structured to optimize opportunity with a sufficient margin of safety. Then, during periods of volatility, and when appropriate, it is about taking advantage of opportunities created by lack of understanding.

CLIENT: I don't understand. How do you protect my portfolio from what Geithner is predicting?

BH: Did you sell your house when the pundits were predicting calamity?

CLIENT: No.

BH: Why not?

CLIENT: Because I know it has value.

BH: Owning the securities in your portfolio is no different. Moreover, one could argue it is even "safer" or "better" to own a diversified portfolio than having all your investments tied up in one house that could wash away in a flood, become demolished in an earthquake or lose value because of human migration.

CLIENT: But stocks are just paper.

BH: So is your house deed and the money in your pocket. These things represent ownership just as stock certificates represent partial ownership in companies that have buildings, real estate, patents, products, customers and other tangible assets.

CLIENT: Okay, but do we have some kind of market protection built in?

BH: The margin of safety that was explained in April's newsletter (call



BARRY HYMAN, MBA

us if you want another copy) defends against permanent loss. Short-term fluctuations are different. Our goal in portfolio management is about investing money in a diversified mix of equity (stocks) and debt (bonds or fixed-income) investments at prices below which they should rationally be selling and actively managing those investments. While it is not about trying to time or avoid market fluctuations, it is about taking advantage of investment opportunities in individual companies, especially those opportunities created by posturing politicians and government officials overreacting to exogenous events.

CLIENT: But what if the debt ceiling is not lifted the market drops and investments collapse?

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BH: Let's look at your portfolio. If the debt ceiling isn't lifted, will people still talk on the phone, use the Internet, and communicate via smart phones and other electronic devices?

CLIENT: Yeah, probably more so.

BH: Okay, so the telecommunications companies you own aren't going to go out of business and become worthless. How about the food companies ... will people still eat? Or pharmaceutical and health care companies ... will people still need health care? Or energy companies ... will people still drive, heat their homes and run their businesses? Not only are these companies not becoming worthless, but it is likely money will flow into them and out of investments that could be directly affected not only by the debt ceiling but the general state of economic affairs, such as banks and other companies overly dependent on credit.

CLIENT: But my investments still might decline in price if the market falls.

BH: Sure, some might. And as panicked investors move money into gold and other supposed "safe havens," the mining and commodity investments we own will likely rise. The foreign currency denominated investments and government bonds in solid AAA-rated economies will likely rise if the dollar falls. And when the panic hits stocks, bonds generally rise. Your portfolio owns all of these assets. This is all part of the big picture and is why your portfolio is built the way it is. But in order to

be a successful investor you need to focus on opportunity, manage risk and accept volatility as your friend.

CLIENT: Volatility as my friend?

BH: Let's look at what recently happened. Japan had a terrible earthquake and ensuing tsunami. I do not want to downplay any of this horrible tragedy. It was terrible, and my heart goes out to all who were affected. But the immediate response of some investors was to sell everything out of panic. As a result, global telecommunications, food, health care, recreation, construction, energy and many other companies' stocks fell sharply. This made no rational sense. One would expect Japan's electrical or property insurance companies' stocks to fall, but it is illogical that companies that had no negative connection to this disaster – even companies who would benefit from the rebuilding of Japan – saw their prices fall.

CLIENT: Can you give me examples?

BH: Events in Japan gave us the unique opportunity to invest in Swiss and Singaporean telecommunications companies, a Belgian investment company, an Australian wind farm and construction materials company, a U.S. solar company, a Singapore-listed office properties company with properties in India, and a Japan-based mining company. We were able to buy all of these companies, whose stocks were already selling at prices well below their intrinsic values, at prices that had dropped

10%-20% further in response to the earthquake. The price of each of these has since rebounded, many to or above the levels they were selling prior to the earthquake.

CLIENT: What did you use for cash to buy them?

BH: Fortunately we had already raised some cash in many accounts. Additionally, we sold some of our existing holdings that held up well but were no longer representing as much of a risk-adjusted value as the companies we bought. During a period of volatility, or a market crash, our strategy is to sell some of our investments that rise, hold their value or decline in relatively small amounts if they no longer represent as much of a compelling value, and deploy the proceeds into those that fall inordinately below their rational values. By doing so, we increase our exposure after things have gotten unreasonably undervalued and thus, in the ensuing recovery, benefit from our disciplined approach to investment management.

CLIENT: I get it. That helps me not get so rattled by the volatility. In fact, I don't mind upside volatility! Okay, thanks. I feel a lot more comfortable. It kind of makes me want to see more volatility, so we can have more opportunities to take advantage of!