MISCONCEPTIONS OF AVERAGE INVESTORS:

Failure to Recognize Importance of Compounding
Failure to Recognize Two Price Trends
You Can't Time the Market
Buy-and-Hold for the Long-term
Astounding Reluctance to Sell Stocks
Investing is Easy

FAILURE TO RECOGNIZE IMPORTANCE OF COMPOUNDING

None other than the esteemed Albert Einstein described compound interest as "the greatest mathematical discovery of all time". Compounding is the process of earning cash returns on your investment, and then reinvesting the proceeds. Sounds pretty boring at first, but after time when the money pot has grown pretty large, it is starting to look pretty exciting! ***This is a fundamental feature of all portfolios managed by 21ST CENTURY – a significant portion of investment return is to be comprised of cash income (through some combination of strategies that generate dividends, interest, or cash returns from out-of-the-money call writing).***

FAILURE TO RECOGNIZE TWO PRICE TRENDS

As the "buy and hold" mentality has been hammered into the subconscious of the average investor, he has come to believe that there is only one trend in the market – up. The staunchest believers of this idea probably did not begin investing in the stock market until after 1982, and therefore never lived through a bear market where the primary trend of the market was down. It is absolutely imperative that investors recognize that two price trends do exist, and then develop a long-term investment strategy that takes these two price trends into account. History tells us that primary uptrends (ie. bull markets) comprise approximately 2/3rd of the time and primary downtrends (ie. bear markets) comprise about 1/3rd of the time. Described another way, in the century of the 1900s the market enjoyed bullish trends for more that 60 of the 100 years, and bearish (or sideways) trends dominated for the balance of that century. A thorough knowledge and interpretation of the three psychological phases of bull and bear markets is absolutely critical in order to successfully navigate today's investing environment.

YOU CAN'T TIME THE MARKET

We've all heard it often repeated by market "experts". I suppose that if you hear it enough times, then it must be true. "You can't time the market, you can't time the market, you can't time the market….." Over and over and over again. Let's examine the statement in detail. First of all, who is "you"? Does the person making the statement refer to me? Or him? Does he refer to the population of all investors? Surely, there must be someone on this planet who is skilled enough to time the market! I thought it was interesting that two legendary investors, and pillars of the investment community, Peter Lynch of Fidelity and John Bogle of Vanguard have recently embraced the concept of market timing. Oh, such blasphemous talk! These extremely intelligent and respected investment community spokesmen are known to be staunch proponents of buy-and-hold investing and "you can't time the market" rhetoric. Well, how about this? On March 17, 2003 a CNBC interview with Mr. Bogle revealed that he had reduced his exposure to stocks to 35% in the late 1990s due to high valuation, but as of that date (March 17, 2003) was more bullish on stocks than bonds. And then on Jan. 28, 2003 Mr. Lynch was quoted that he now likes stocks, and had dramatically increased his exposure to equities. The argument is not whether their statements were right or wrong. In fact, their assessments of market conditions appear to have been right on the mark. The point is that those statements represent the absolute practice of market timing, rather than the buy-and-hold model of being invested at a predetermined asset allocation 100% of the time. My take on the subject is this: I think you can time the market. You can't afford not to. ***Bull and bear markets have identifiable traits and characteristics that the astute student of the market should be able to identify.*** As a result, investors can develop strategies that avoid the bulk of the damage inflicted in bear markets, and could then make appropriate adjustments when bullish investing environments reappear. To the guy who says, "you can't time the market" – I think he should take the time to study market history, and maybe just work a little harder!

BUY AND HOLD FOR THE LONG-TERM

"Buy-and-hold" basically entails: 1) a one-decision investment strategy that consists of buying a diversified basket of securities in predetermined relative amounts; 2) holding that basket of securities through all market environments (both good and bad); 3) adding to the basket on a systematic and periodic basis; 4) periodically rebalancing the portfolio when the portfolio components get out of balance through time; and 5) selling the portfolio when the investor needs the money. In theory, the long run will bail the buy-and-holder out of the bad market environments because of the long-term upward bias in the market. But how about the buy-and-hold investor who bought into the market in February 1966 and woke up an August day in 1982 to find out that the Dow Jones Industrial Average had fallen nearly 22% during that 16 1/2 year period? Would he have had enough nerve to sit tight through the destructive 1973-1974 bear market? I doubt it, I sure wouldn't have. So that's one big problem – the irresistible temptation to tamper with the predetermined asset allocation possibly due to disappointing performance of some of the portfolio's components. As the asset allocation is arbitrarily adjusted – say, for instance, mid-way through the 2000-2002 bear market, he decided to increase the allocation to bonds (just because the stock market was making him sick to his stomach) - he has now, in effect abandoned buy-and-hold and become a market timer. Lastly, and perhaps most importantly, the buy-and-hold mentality could result in a rigidity of one's views – rigidity is implicit in the mechanical nature of the strategy itself. I think that successful investing should include the flexibility to change one's views about the market from time to time. Sometimes stocks are cheap, and sometimes they are not – that's just the way it is. I would like to reserve the right to adjust my investing strategy as the times dictate.

ASTOUNDING RELUCTANCE TO SELL STOCKS

The “buy and hold for the long-term” mantra that has been driven into the heads of amateur investors has created the mistaken impression that a stock (or mutual fund) is something that is not to be sold – ever. But of course, markets swing from one extreme to another over time – from under-valuation to over-valuation and then back again – and such is the case with individual securities and mutual funds. Also, circumstances change from industry to industry dictating sales when appropriate. So why the fear of selling? The reasons are numerous and include the following thought-patterns: 1) “If I sell now, the stock may still go up”; 2) “If I sell now, I’ll give up the chance to recoup my losses”; 3) “I don’t know what a stock is worth”; 4) “If I sell now, I’ll be committing a crime and may be incarcerated by the SEC”. The process of selling is quite complex and detailed, not explainable in a short piece such as this, but I will tell you this much: the selling discipline is an integral component of the investment process that would necessarily involve 1) a thorough knowledge of price patterns and trading ranges of individual issues; 2) recognition of a price breakdown when in process (many investors typically believe that a stock represents a good “value” during the breakdown stage – this is an often repeated, and critical error, in my opinion); 3) a thorough knowledge of the subject of business valuation; and 4) a thorough knowledge of the characteristics of bull and bear markets. Without a well thought-out selling process, the odds of success in investing are likely to be slim.

INVESTING IS EASY

I’ve been thinking that I might abandon this low paying investment management business for the more lucrative heart surgery profession. I mean, how hard can it be? You get a chart of the arterial system, make sure your scalpels are sharp at all times, and the book gives you not one, not two, but six lessons in the art of heart surgery!

I can understand how the average investor might think that this investing business is pretty easy. What’s there to do? You can keep your full-time job and all you have to do is buy a diversified basket of mutual funds once in your lifetime, in other words, buy and hold for the long-term figuring that its going to work out by the day you get your gold watch. And plus you never even have to make a sell decision! Seriously, I recognize that there is absolutely no contest as to which profession contributes the greatest value to society – it would like comparing The Looney Tunes theme song to Beethoven’s 9th Symphony. But as far as difficulty, or said another way – the ease in which professional excellence might be achieved, the comparisons of the two professions are similar.