

There are many factors that must be considered in developing an investment strategy:

- Should you invest in equities?
- Do you want to invest in foreign or domestic securities?
- Do you want to invest in small cap common stocks?
- Do you believe growth stocks or value stocks offer greater opportunities for the future?

These issues are all important. However, in the long run, none of these factors will have a greater impact on rate of return than the allocation to equities.

Loaners vs. Owners

To understand this we must first understand equities in general. All investments can be separated into two classes: debt or equity. Investors in debt-type investments are loaners and investors in equity-type investments are owners. Investors in debt-type investments loan their wealth with specific terms. They receive a promised rate of interest and their principal is returned at a promised date. The strength of the promise and the date of the return of principal determine the rate of interest that is paid. Investors lending to the United States of America with a promise to return the principal in one year expect a low rate of interest. Investors lending to corporations with a "maturity date" 20 years in the future expect a higher rate of interest.

Risk vs. Return

The difference in the rate of interest is a reflection of the difference in the risk associated with these investments. The United States of America is a better credit risk than a corporation. Our government can tax us to repay their debt. A business must earn a profit to repay our debt. There is a greater risk that a business will fail to earn a profit than there is that our government will fail to collect enough taxes. The longer an investor must wait to reclaim his principal, the greater the chance the borrower will develop financial trouble or that other economic factors will arise (such as changes in interest rates) that impair the value of the loan. Therefore, long-term loans to high credit risk borrowers require higher interest rates, while short-term loans to low credit risk borrowers require lower interest rates.

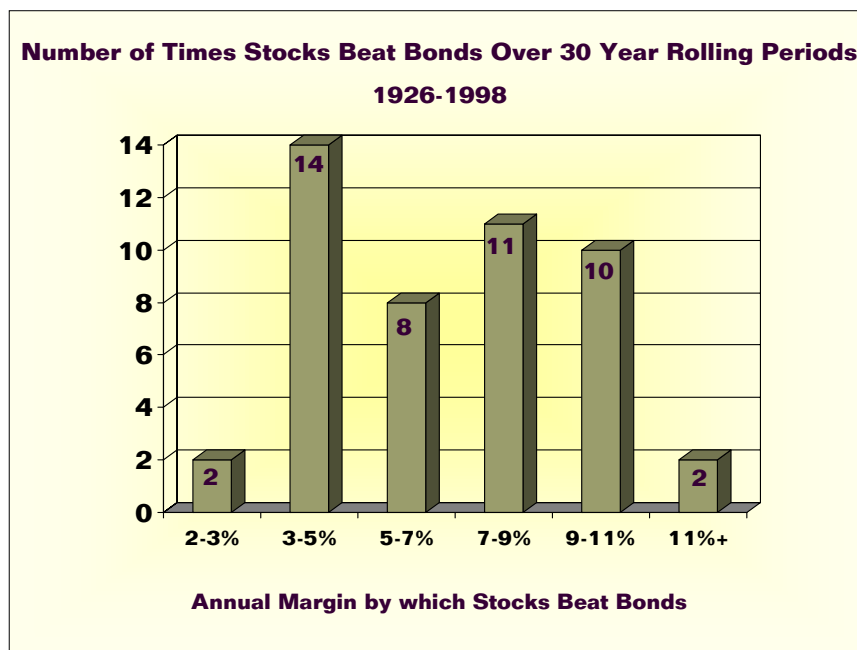
Equities are altogether different. An equity investor owns something or a piece of something. An owner of real estate owns something without a stated financial value. A piece of real estate is worth whatever someone will pay for it. There is no maturity date. There is no rate of interest. An owner of real estate may rent his property, but there is no guarantee that he will be able to. And there is no guarantee that he will ever be able to sell it. This is a much less certain investment and therefore *investors demand a higher rate of return.*

Common stocks have similar ownership characteristics. Investors in common stocks own a portion of a business. If the business is profitable, they own a portion of the profit. If the business increases in value, the value of their ownership increases. But there are no guarantees. The business may not earn a profit and may not increase in value. If an investor would like to sell his investment, the business is not obligated to buy it back. He must find someone else who would like to buy it from him.

It is human nature to avoid risk and to seek certainty. We will accept a lower rate of return in exchange for greater safety. However, we often have an excessively short view within which we evaluate the safety of our investments.

What History Tells Us

Since 1926 there has been no 30 year period during which common stocks have failed to produce a higher rate of return than debt-type investments (bonds). The closest was 1966 through 1995 when stocks only beat bonds by 2.72% per year. The worst absolute return for common stocks was 1929 through 1958 during which time stocks returned an annual rate of 8.47% and bonds returned 2.85%. The best absolute return for bonds was 1971 through 2000 during which time bonds returned 9.27% and stocks returned 12.67%. In that sense, common stocks can be viewed as "safer" than bonds over 30-year periods. The chart below shows the number of times stocks beat bonds over the forty-four 30 year rolling periods from 1926 through 2001, grouped by the margin of outperformance.



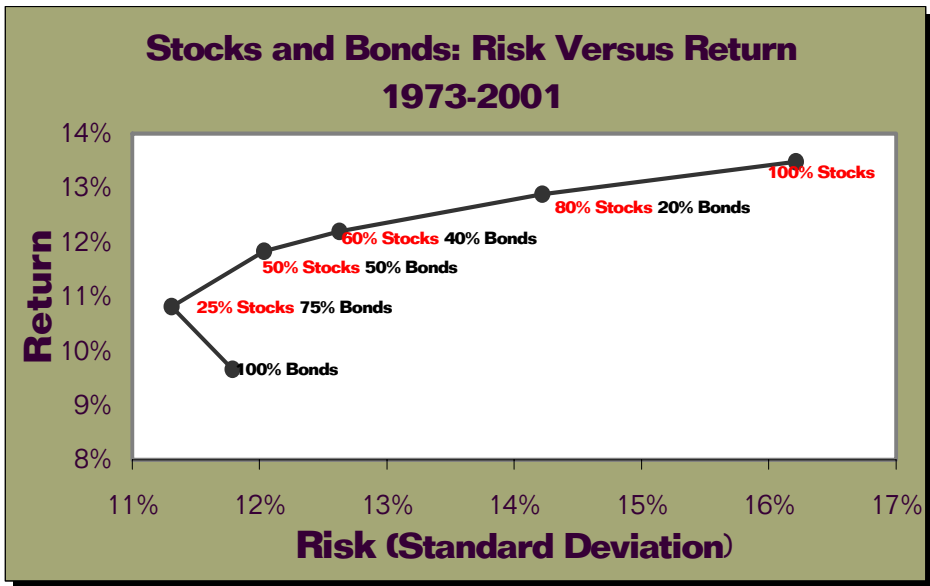
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Making the Best of Both

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When combined, common stocks and bonds produce a diversification effect that reduces risk. A portfolio with some common stocks can be less risky than a portfolio with no common stocks. This could result in a higher rate of return with a lower risk. An even higher allocation to equities can give an investor a higher rate of return with just a slight increase in risk.

Beyond the fact that common stocks are superior long-term investments, they can add safety in the short-run! This is an amazing statement to most people. During the period 1973 through 2001 a portfolio of 100% bonds returned 8.95% per year with a standard deviation for one-year returns of 12.3%. (Standard deviation is a measure of risk. A higher standard deviation implies a higher risk.) A portfolio of 25% stocks and 75% bonds produced a return of 10.3% per year with a standard deviation for one-year returns of 11.5%. During this period adding stocks increased return while reducing risk in the short-term!



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This amazing result was achieved as a result of "The Diversification Effect". This effect will be reviewed later in another discussion. For the moment it is sufficient to say that any time two investments are combined that have different return characteristics, the result will have lower risk. This effect can be exploited more broadly by adding other asset classes. Here we are simply discussing the allocation between stocks and bonds. For this reason every portfolio should have at least a 25% allocation to common stocks.

It's The Mix That Matters

The debt/equity ratio has a greater impact on long-term results than whether investors favor growth or value, large or small, U.S. or foreign equities. For instance, one dollar invested in large company stocks in 1926 would have appreciated to \$2,279 by the end of 2001. That same dollar would have grown to \$7,860 in small company stocks. Had one invested one dollar in long-term government bonds over the same time period it would have grown to only \$51. A dollar invested in long term corporate bonds would have grown to \$61. In other words, over long periods of time, whether an investor prefers a fixed income-type of investment versus an equity-type investment will have a greater impact on the overall performance of his or her investment than whether he or she prefers small cap to large cap stocks or corporate bonds to government bonds. Balancing the need for the long-term return of equities with the need for the short-term safety of debt is the most important element of the investment process.

Striking the balance between return and safety is what determines an "appropriate" allocation to equities. For each individual investor this term varies in meaning. The time horizon of the investment is a good indication as to how much of an allocation to equities is appropriate. The first step all serious investors should take is creating investment goals and objectives. Once these goals are clearly defined, they should be separated into their respective time horizons. The appropriate allocation to equities would be quite different for next year's home improvement as opposed to a young child's educational funding or for long-term financial independence. Another question to be addressed is tolerance for volatility in the short run (which could be 3-5 years). Likely, an allocation of 100% equities is as safe as 100% bonds over 30-year periods, but the investor must be able to withstand short-term losses. Even for the most cautious long-term investor it is apparent that the risk of equities hardly seems excessive.

Summary

One of the most important investment decisions an individual can make is the determination of an appropriate allocation to equities. Popular beliefs have always and continue to label bonds as a "safer" investment than equities. History demonstrates that an appropriate allocation to equities is prudent and wise. Historical data indicates that a mix of stocks and bonds can actually reduce risk in addition to increasing returns. Having an appropriate allocation to equities is absolutely necessary for the successful investor.

Sources of Data

Stocks: Standard & Poor's 500 Stock Index Total Returns

Bonds: 20-Year U.S. Treasury Bonds Total Returns