

## Are Alligators More Dangerous When You Can See Them Or When You Can't?

*One Saturday a family of four with two young boys took a guided wilderness tour by airboat in the grassy tributaries of the St. Johns River. Mom and Dad were astounded by the spectacular scenery and abundant bird life, but the two boys had only one thing on their minds – alligators. Every log on a sandbar or stick floating by brought a moment of excitement in hopes of the first alligator sighting of the day. But as the day wore on and each log was a log and each stick was a stick the boys became evermore disappointed. Finally, when the guide turned the boat for home without having seen a single alligator, the boys lamented their bad luck complaining they did not see any alligators. The guide replied: “They saw us .....*”

*Risk in the stock market is a bit like alligators in Florida - always there, but not always visible. The stock market alligators have been very visible for the last few years. Their appearance has terrified many investors. But like alligators, the most dangerous stock market risks are the ones you don't see.*

*Investing in common stocks is always risky. After three of the toughest years in the history of common stocks, with worries about conflict in the Middle East, tension about the SARS virus and a “jobless recovery” at home, the risk is fresh in investors' minds. Stock market investing seems more risky now than at other times. This feeling of risk has driven many from the market and has many others on the verge of liquidating their common stocks.*

*As of September 30, 2003 the Dow was up 30% from its low and some are wondering if it is safe to get back in the market. Market pundits are lining up on both sides. Some say the fundamentals are lousy, the recovery cannot be sustained, funding the reconstruction of Iraq is going to be a major problem and we should use this “bear market rally” as an opportunity to get out. Others say earnings reports are beating expectations, technology companies are leaner, better-managed enterprises and we are poised for an explosive period of growth.*

*The February 26, 2003 issue of The Wall Street Journal ran an article by Jonathan Clements titled “Strap Yourself In: Here Are Six Reasons To Stick With Stocks in a Scary World.” This is a great article and worth reading. In this article, Mr. Clements said: “Eventually, of course, it will be safe to invest in stocks again. But at that point, the Dow Jones Industrial Average will probably be 30% higher.” His point was; investors need to stay in the market no matter how scary it looks because the recovery will come suddenly and by surprise.*

*Mr. Clements' overall message is completely correct. Moreover, his timing was pretty good - the market has staged a dramatic recovery since February 26. Mr. Clements looks positively prophetic in hindsight. However, it will never be “safe” to invest in stocks again. It has never been “safe” to invest in common stocks. The idea that it is ever*

*“safe” to invest in common stocks is in direct conflict with successful long-term investing. It is the concept that investing in common stocks is ever “safe” that gets investors into trouble.*

*The higher long-term returns available in common stocks exist **because of** the risk. The return is compensation for the risk. “Safely” investing in common stocks can only be achieved over long periods of time with the acceptance that there will be bad markets. “Safely” investing in common stocks requires the commitment to stick with it through the good and the bad. “Safely” investing in common stocks demands reasonable expectations.*

*The risk-reward tradeoff and sticking with common stocks through good and bad is consistent with Mr. Clements’ overall message. It is very telling, though, that he could say that stocks will one day be safe when the concept of safety is in direct opposition with the concept of the risk-reward tradeoff. Mr. Clements has written extensively about prudent diversification, selecting an appropriate asset allocation and sticking with a plan consistently over time. It is almost shocking for someone who has written so convincingly that it is not possible to predict the market to say that it will one day be safe to invest in common stocks. It is ironic and borders on comical that this statement could be made in an article making the point that investors should stick with their allocation to common stocks regardless of how bad things look.*

*The notion that it is sometimes safe and sometimes risky to invest in common stocks is a belief held very deeply by most investors. Shedding this belief is critical to making peace with a sensible long-term investment strategy. Capital markets provide compensation for taking risk. The more risk, the more expected compensation. The market may appear safe at times, but this is an illusion. The alligators are just well hidden, but they are there. Accepting that they are always there will make it a bit less scary when a stick turns out to be an alligator head. Alligators are scary to see, but they are more dangerous when you don’t see them.*

*So should you believe those who say we are on our way back to Dow 10,000 and higher? Or should you believe those who say this is a “sucker’s rally?” Well, if you are still asking that question, you have not been paying attention. But you probably are still asking since this question is so deeply rooted in the psyche of most investors. This is a topic that comes up in the investment strategy committee meetings of investment institutions who are completely committed to the idea that it is impossible to predict the direction of the stock market. So let’s address this question even though we should not be asking it. What should investor do now? Of course, the answer is – it depends.*

*Unfortunately, there is no way to know if 2003 will end up like 1938 – a good year in a bad period, or like 1987 – a good beginning with a bad ending, or more like 1975 – the beginning of the best 25 years in the history of the U.S. stock market. The answer to the question - “What should you do with your portfolio?” depends on you. If the last three years was a torturous period during which you lost many nights of sleep worrying about your finances, your investment policy may be too aggressive and you should consider*

*using the good market in 2003 as an opportunity to sell some common stocks and become a little more conservative. But be careful. Do not become more conservative now if you will be tempted to get more aggressive again after a few good years. You want to settle into an asset allocation to which you will remain committed until your financial circumstances dictate a change.*

*On the other hand, if you have slept well for the last three years, confident in the long-run health of capitalism, then your investment policy is probably appropriate and you should stick to your guns. Just remember, the alligators will always be there. Sometimes they are snoozing in the grass, sometimes they are out cruising for food, but they are always there and you never know when they will get hungry.*