

Investment Truths Applicable in Good Times and Bad

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In the current economic environment, investing seems to be a tricky proposition. It is easy for investors to succumb to the pressures of the stock market and make a decision to seek safety. When the stock market gets beaten down week after week, many investors fall victim to a common psychological urging. Many investors believe it is best to get out of the market in order to stop the financial bleeding. Unfortunately, this could cause severe damage to an investment portfolio's returns in the long-run.

When investors cash out of a down market, they ensure several results. First, investors realize real losses, which were previously only paper losses. Second, future investment returns can suffer from "opportunity loss". Opportunity loss, in the case of investing, is when your return suffers from not being a part of the market when the market eventually heads into positive territory.

What are we, as investors, to do in such a challenging investment environment? Should we get out and wait for good times or should we ride the bumps and let time work its magic? There are, in fact, some investing truths which can help investment portfolios survive tumultuous times and do well in good times.

Long-term or Short-Term

Successful investing is a long-term game – period! There are no safe "get-rich-quick" schemes in investing. There is no return without risk. Excessive upside returns relative to the general market carry with them significant risk and, usually, excessive downside returns when the market is down. Day-trading based on ultra-short-term indicators is simply foolish. And, the list goes on.

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On the surface, professional investing is actually quite simple and relatively low-maintenance when a good strategy is established. Once a strategy tailored to an investor's specific situation is in place, the process of investing becomes a slow, long-term game not unlike Chess. Professional investors make small moves along the way with a long-term goal in mind. Knee-jerk moves based on short-term trends usually end miserably.

Diversification

Investors have heard the word "diversification" often. However, do investors really know what it means in application? Diversifying a portfolio is a way to mitigate risk. In academia and in practice, the benefits of diversification do not start to appear until one holds maybe 35-40 stocks in a portfolio. Further, there must be a good balance across economic sectors and industries within the stocks you hold.

The benefits of diversification are related to a simple statistical measure called "correlation". When the correlation between the returns of two stocks is low, the benefits of diversification begin to have a meaningful impact. For example, if the returns of two stocks have a "negative 1" correlation, there exists a perfect inverse relationship. In this theoretical situation, if one stock were hammered, the other stock would likely offset the first stock's losses to some degree. Thus, if one builds a well-planned portfolio where the number of stocks is meaningful and diversification is effective (correlations are low), the portfolio can have greater power to protect assets in down markets.

Stocks vs. Inflation

Stocks have historically been the best investment vehicle with which investors can earn attractive long-term returns and outpace inflation. After all, inflation is the ultimate enemy. Inflation eats away at your spending power. If your money is not able to grow

faster than the rate of inflation, your principal is reduced over time. Since about 1900, stocks have beaten their next closest competitor (bonds) about 53 times over.

The risk that comes with stocks' tendency to out-perform over the long-term is shorter-term volatility. Year-to-year variations in stock returns can be troubling at best and downright damaging at worst. Thus, many investors fall into the aforementioned trap of getting out of the market when things are bad. This is usually a big mistake. Normal human psychology causes many people to bail out when things are bad (ie, when prices are beaten down) and get in when things are good (ie, when prices are high). The key is to fight the emotional side of investing and try to make sound business decisions about investing. If investors could recall stocks long-term relative out-performance and avoid the knee-jerk reaction of getting out of a low market, the long-term benefits could be tremendous. Further, the opportunity loss investors may suffer when they are on the sidelines when the market begins moving up could add additional damage.

Quality Counts

Stocks of quality companies tend to be a foundation of good investing strategies. We know from empirical evidence that a company's stock price ultimately goes where the company's earnings go, over time. Stock price and earnings do not always follow the exact same ascension path, but they generally rise or fall along similar trend rates.

What does this tell us about owning quality stocks of quality companies? If investors own stock in quality companies with real earnings, and that company performs well (as measured by steady earnings growth), one would expect the stock price to do well over time.

Thus, the question becomes how do investors identify a quality stock and a quality company. Broadly speaking, quality can be identified by a company's industry leadership, product/service offerings, quality of management, steady long-term upward earnings trends and sound financial status (cash levels, debt levels, etc.).

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Companies in turn-around situations, with unproven products or services, suffering from earnings declines, or laggards in their industry should be approached cautiously and only by professional investors.

Market Timing

Timing the market does not work. Phrases such as “now is time to get out” or “now is the time to get in” are complete nonsense. An exception could be when very well-planned dollar-cost averaging is used in certain investment environments. However, in general, any flat proclamation that it is time to get into or out of the market is irresponsible at best. If anyone advises you of such, you have just met someone who does not truly understand long-term professional investing.

Working With a Professional

The gold-standard professional certification in the world of investment management and securities analysis is the Chartered Financial Analyst (CFA) designation. In order to pass the CFA exams, one must take three 6-hour exams. Each exam requires approximately 250 hours of graduate-level and PhD-level self-guided academic study. The recent pass rates exemplify the truly rigorous nature of the CFA program. In 2008, the Level I, II and III pass rates were 35%, 46% and 53%, respectively. As you search for professional assistance with your investments, look for a professional who holds the CFA designation.

Summary

The world is not ending. We are not in a new paradigm. The sky is not falling. The U.S. economy and stock market have suffered from, and survived, the shocks of WWI, the Great Depression, WWII, Korea, Vietnam, the 1970's oil embargo, several terrorist

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strikes (9/11 in particular), Y2K hype, and many other notable domestic and world events.

History tells us that, unless the world is ending, the stock market will recover again. Investing is not without risk. Have patience and rely on these simple investment truths, which will show us the way to the light at the end of the tunnel.

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