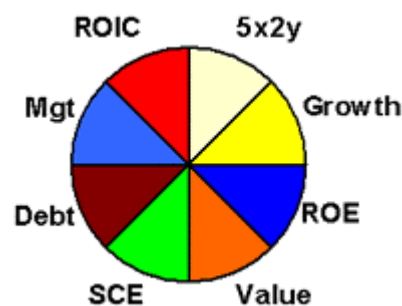


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INVESTING: A LOSER'S GAME II

Well, it's New Year's Eve... a time to reflect on the ecstasy and agony of market moves during the year past. You can't win them all, but as we discussed in the first article in this series, it is downright scary how often we lose. Not to lose hope, let us finish up the year discussing how to improve our odds of winning (beating the market) beginning with a fresh start in 2003.

First, let's vow to take our time next year as we make logical investment decisions. Any decision made in a hurry is likely regretted in a hurry. Quick investment decisions are often the result of a less-than-rigorous investment policy. Firm up your policy. WallStraits follows an 8-step screening process, which keeps us from making hasty decisions (pie chart). At the same time, as you run various businesses through your rigorous screens over and over, you become more proficient and can act relatively quickly and confidently when opportunities arise.



Love the Bear, not the Bull

Policy prevents panic. Investors are people and, like all people, make decisions based on their emotions when a cool, rational analysis would call for very different actions. Ironically, as human beings, investors love rising bull markets and hate falling bear markets--even though falling stock prices are in their best interests. Sound really strange? Well, bear with me a moment as I explain.

In theory, our long-term interests are best served by lower stock prices, but who among us can honestly say that he or she does not feel a warm glow of affection for stocks and markets that have gone up even though it means stocks are now more expensive to buy and future rates of return on additional investments at these price levels will surely be lower? Who among us would close our wallets and turn away

from the store that puts its most attractive wares on sale at 10, 20, or even 50 percent off normal prices?

Few of us would say, I don't want to buy these things when they're on sale; I'll wait until the price goes back up and buy then. But that's exactly how we behave toward investments. When the market drops--putting stocks on sale--we stop buying (in fact, we even sell in a panic). And when the market rises, we buy more and more enthusiastically. If we shopped for stocks the way we shop for socks, we'd be better off. But we are wrong when we feel good about stocks having gone up, and we are wrong when we feel bad about stocks having gone down. A falling stock market is the necessary first step to buying low.

Remember what our dear friend, Mr. Warren Buffett said about loveable teddy-BEAR markets... The most common cause of low prices is pessimism--sometimes pervasive, sometimes specific to a company or industry. We want to do business in such an environment (bear markets), not because we like pessimism but because we like the prices it produces. It's optimism that is the enemy of the rational buyer.

Why are we such an Emotional Wreck?

Investors aren't stupid--but we are generally ill-prepared for the stock market experience. Psychologists who study fear and anxiety have found that four characteristics make people more worried about the perceived riskiness of a situation than the realities would warrant: large-scale consequences, the lack of personal control or influence, unfamiliarity, and sudden occurrence. As a result, we are more fearful of air travel than travel by car--even though statistical facts point to only 30 annual deaths in airplane accidents, versus 30,000 deaths in car accidents.

Likewise, most investors experience great anxiety over large-scale, sudden, and frightening losses in portfolio value primarily because they have not been informed in advance that such events are expected and considered *normal* by those who have studied and understand the long history of stock markets. Such drops in the market are-- with a good understanding of market history-- eminently predictable, not in their timing but in their magnitude and suddenness. And it is in these periods of anxiety-- when the market has been most severely negative-- that investors

tend to question their long-term investment judgment, which allows short-term fears to outweigh long-term policy.

You can substantially improve your long-term portfolio returns by being sure you are well prepared for the realities of the market. Understand that while the stock market has offered average annual returns of about 10% over the last 50 years, seldom has any one year hit just right at 10%. In fact, the worst year was -43% and the best was +54%. That's a very wide range that you need to be prepared for. If you're not in the market with a long-term mental attitude--you are unlikely to achieve the promised long-term rewards. Take some time to study history-- and start with a study of volatile years like 1928, 1957, 1962, 1973, 1987, 1999, 2000, and 2001.

Question: If you had your choice, which would you prefer?

- A: Stocks go up by quite a lot and stay up for many years.
- B: Stocks go down by quite a lot and stay down for many years.

Well, by now you are wising up, and probably suspect B is the right answer. However, 90% of individual investors instantly choose A, as do the vast majority of professional fund managers. Unless you are a long-term seller of stocks, you would have chosen against your own interests if you chose A. First, remember that when you buy a common stock, what you really buy is the right to receive the dividends paid on that share of stock. Just as we buy cows for their milk and hens for their eggs, we buy stocks for their current and future dividends. If you ran a dairy, wouldn't you prefer to have cow prices fall and stay low as you are stocking your milking barn so you could get more gallons of milk for your investment in cows?

The lower the price of the shares are when you buy, the more shares you will get for every \$1,000 you invest and the greater the amount of dollars you will receive in dividends on your investment. Therefore, if you are a net saver and a buyer of shares-- as most investors are and will continue to be for many years-- your real long-term interest is, curiously, to have stock prices go down quite a lot and stay there so you can accumulate more shares at lower prices and therefore receive more dividends with the savings you invest.

Most investors, being all too human, much prefer stock markets that have been rising and feel most enthusiastic about buying more shares when stock prices are already high, causing the future rate of return from their dividends to be axiomatically low. (The dollars of dividends to be received will be the same per share of stock whether you pay a lot or a little for the shares.) Similarly, most investors feel quite negatively about stocks after share prices have gone down and are most tempted to sell out at the wrong time--when prices are already low--and the future dividend yield on the price paid will be high.

Don't Gamble

Finally, don't gamble with your investments. Don't set yourself up for serious, irrevocable losses. Naturally, you can't invest without absorbing lots of small interim losses-- a stock bought at a bargain price today can easily fall to an even better bargain tomorrow in a irrationally pessimistic market (just look at the STI today!). Markets do fluctuate, and nothing ventured, nothing gained-- when a stock is a bargain you need to buy, which exposes you to paper losses. But don't take unnecessary and excessive risks. Don't swing for the fences. Don't invest with borrowed money. There are old fighter pilots and bold fighter pilots--but there are no old, bold fighter pilots.

If you find yourself getting caught up in the excitement of a rising bull market or distressed by a falling bear market, stop. Take a break. Get away from the daily prices for a few days and cool down. Otherwise, you will soon become part of the irrational crowd--and you will start making errors, perhaps grave errors that you will regret. Buffett says, Inactivity strikes us as intelligent behavior. Become inactive when stressed or excited-- it's the secret to long-term investing success!

Simplicity

Have a firm consistent investment policy, stick to it through thick and thin, be prepared for the volatility of the markets, learn to enjoy low prices offered during bear markets along with the higher dividend yields low prices bring. Sound too simple? Well, remember the wisest advice in the medical industry was-- wash your hands. The best advice on how to live longer-- quit smoking and buckle up when driving. Good advice often appears oversimplified. Soundly conceived, persistently

followed long-term investment policy *is* the pathway to success in investing. Winning the Loser's Game of beating the market is easy: *don't play it!* Concentrate on the Winner's Game: defining and adhering faithfully to sound investment policy that's right for the market realities and right for your long-term goals and objectives.

You now know all you need to know to start down a more enjoyable and rewarding investing path beginning in 2003. Either begin to play the Winner's Game, or accept the market returns of a low-cost index fund. The choice is your.

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Disclosure: Much of the material for this series of articles was extracted from a recent book by Charles Ellis, *Winning the Loser's Game*, 2002, McGraw-Hill, ISBN 0-07-138767-6.