

SCHULTZ COLLINS LAWSON CHAMBERS

INVESTMENT COUNSEL

Question: What are these numbers?

I	II	III	IV
-19.93%	-7.37%	3.82%	8
-26.81%	-1.31%	5.72%	27
31.73%	-15.91%		
20.33%	36.62%		
11.95%	14.43%		
12.31%	5.46%		
4.58%	15.44%		
10.52%			

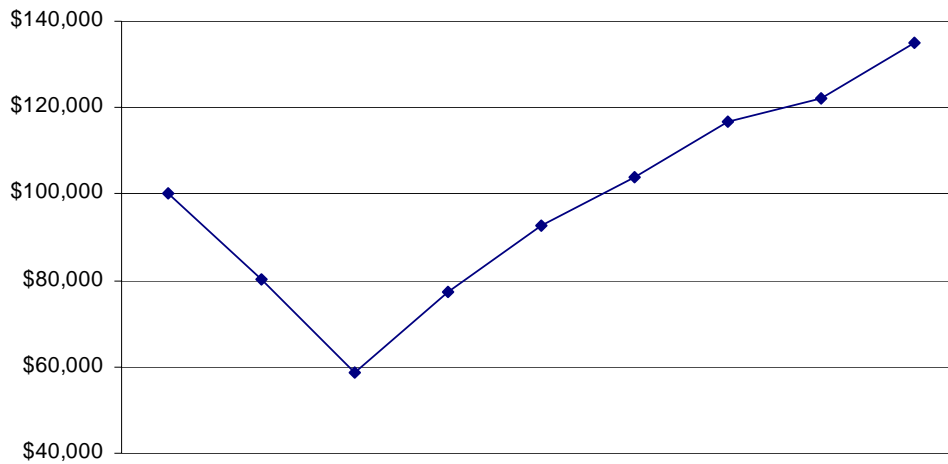
Answer: These numbers are all realizations of what economists call a “return generation process.” In this case, they are produced by a portfolio allocated 80% to stocks and 20% to bonds. For a more complete answer, see below.

Question: What is the return generating process underlying a globally diversified portfolio allocated 80% to stocks and 20% to bonds?

Answer: No one knows. The “true” underlying return generation process for world capital markets is unobservable and unknown. The best anyone can do is to make inferences about it given its past realizations. The numbers above provide an interesting glimpse into the return generation process.

Sequence I is the annual inflation-adjusted (“real”) return earned by investors in 80-20 portfolios over the period 1973 through 1980. In graphic terms, here is what happened to an initial investment of \$100,000:

80-20 Portfolio
Inflation-Adjusted Results 1973 Through 1980



In two years, the constant dollar portfolio value fell from \$100,000 to \$58,603. Furthermore, the slide evidenced increasing acceleration. For investors, there was no “bottom” in sight. However, ending constant dollar portfolio value in 1980 was \$134,993.

Sequence II is the annual inflation-adjusted return earned by investors in 80-20 portfolios over the period 2000 through 2006. The initial slide was not as pronounced as during the period beginning in 1973, but it lasted longer. Ending constant dollar portfolio value in 2006 was \$147,561.

Sequence III is most amazing. For the period 1973 through 1980, investors in an 80-20 portfolio earned a real compounded annual return of 3.82%. This means that their portfolios beat inflation by 3.82%, so that their real personal wealth actually increased during the period! For the period 2000 through 2006, investors beat inflation by a whopping 5.72% per year.

Sequence IV indicates the number of calendar years, beginning in 1973 and continuing through 2007, that an 80-20 portfolio has decreased in constant dollar value (8) or increased in constant dollar value (27). Assuming that the portfolio decreases in value in 2008, the down/up ratio will be $9 \div 27 = 1/3$. For every one year that the 80-20 portfolio failed to keep pace with inflation, there were three years of positive growth in personal wealth.

Question: But isn't it different this time?

Answer: Of course. The nature and magnitude of economic shocks always differ period to period. In some periods, shocks (“disturbance terms” to an economist) are relatively mild; in others, they are highly virulent. One thing in common, however, is that they always differ.

Question: Has anybody studied the shocks?

Answer: Yes, there is rich and fascinating literature on this topic. Studies have looked at shocks throughout world markets for 150+ years. There are a few things to keep in mind. First, economic shocks tend to occur in clusters. Periods of extreme volatility are suddenly followed by periods of calm (and vice versa). Second, stock prices always struggle to reconcile two economic forces, the dark and the light.

We'll call the dark force by its econometric term: "the leverage effect." As the price of a firm's stock drops, the value of its equity decreases, and its debt to equity ratio becomes less favorable. Therefore, investors perceive it to be more risky, which raises the discount rate (the rate at which expected future cash flows are discounted). The increased discount rate, in turn, depresses the value of the firm's equity, which causes the debt to equity ratio to rise, and so forth and so on. The dark force sends the firm into a death spiral.

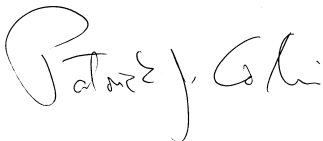
We'll call the good force by its econometric term: "the volatility feedback effect." Assuming a company's future dividends remain more or less constant – that is, assuming no great changes in its day to day business operations – any downward volatility of its stock price should increase expected future returns. Thus volatility becomes an indication of future expected risk premiums – the "premium" being the excess return that investors may expect to receive for accepting the risk of owning volatile investments.

Note well that, for any particular company, the leverage effect may quickly overwhelm the volatility feedback effect. This is why holding only a few stocks can be very dangerous. Much of the media commentary on the current market turbulence is aimed towards or given by stock *traders*, rather than *investors* holding diversified long-term investment portfolios. Traders are by nature more alive to the leverage effect, because they are more interested in the near-term future price of the stocks they hold. Long term investors, by contrast, are more interested in the volatility feedback effect: they want the excess return they can earn over the long run by owning volatile stocks, and are thus more tolerant of short term volatility.

Question: Will good answers come from politicians in Washington? Should I base my investment decisions on political actions or inactions?

Answer: Probably not.

Very truly yours,

A handwritten signature in cursive script that reads "Patrick J. Collins". The signature is written in dark ink and is positioned above the printed name.

Patrick J. Collins PhD, CLU, CFA

.....