

J.E. Wilson Advisors, LLC

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Banks, Brokers, and Others

These are interesting times indeed for big banks and big brokerage firms. In theory the brightest and best minds of finance have suffered billions of dollars of losses stemming from the broad categorization now known as “sub-prime” mortgages. The underlying core problem was (and likely still is) their institutional mindset of rewarding risk as long as it paid off. Oh, and they also dramatically underestimated the likelihood of the rare yet possible and consequential negative event. The collective total losses from the “sub-prime” mess now exceed \$100 billion and all of this has happened in less than one year.

It might be instructive and useful to spend a moment differentiating between big banks (Citicorp, Bank of America, etc.), big brokers (Merrill Lynch, Solomon Smith Barney, etc.) and the transactional brokerage firms like TD Ameritrade and Schwab. Firms like TD Ameritrade do not operate as investment banks and don't do corporate debt or equity underwriting. Nor do they for the most part take substantial inventory positions in securities. They make money mainly from transaction charges and spreads on their money market fund balances. Conversely, the big banks and big brokers *do* take large inventory positions in securities as they perform investment banking activities. If these securities are brought into inventory and suddenly become worth far less (as happened with most of these entities starting last summer), they can incur *huge losses*. Merrill Lynch has about \$40 billion of capital and managed to lose most of that amount (an estimated \$23 billion at last count) in a matter of a few months. There could still be more yet to come for these institutions. While it still may be unlikely, it is certainly in the realm of reason that one of the big brokers or even big banks could “fail” (or at least come hat in hand to the federal government to bail them out). The market may demand that the internal “risk at any cost” mentality prevalent in many of these entities be corrected before their longer term prospects are brightened.

“What’s needed is a sound intellectual framework for decisions and the ability to keep emotions from corroding that framework.” –Warren Buffett

The Tyranny of the Urgent

Brian Wesbury writing in *The Wall Street Journal* January 28, 2008 (The Economy is Fine- Really) warns against what he terms “the tyranny of the urgent.” I think that is excellent advice not only for the current environment but for all investment periods. Investing is by definition a long term (meaning at least several years in duration) activity and we should not fall prey to our emotional responses to the ups and downs of the short term market. We can only undo our long term objectives by trying to out-guess or out-select. The real risk currently may well be sitting on the sidelines in cash.

Minimizing Losses in Turbulent Markets

Investors who want the long term rewards from investing in equities have to be willing to accept the inevitable market turbulence. Diversification among asset classes and short term fixed income often help temper the short term pain. To receive the returns, however, investors “must be seated at the table” when the unpredictable big upswings occur. From October 2002 to October 2007, the S&P 500 index more than doubled (+101%). Most non-US equities were even higher. The returns can occur quickly and on the border of seemingly poor market conditions. Capturing what the market provides during the good times should allow for the ability to deal with the setbacks when they inevitably occur. Think of it like a savings account where the market makes deposits over a period and then goes through a phase of withdrawals before resuming the deposit/buildup phase once again. The reserves that are created during the buildup phase provide a cushion for the withdrawal phase.

A review of monthly returns from U.S. Small Value and Micro Cap (the 2 highest risk/highest return categories) provide some insight into the quickness by which returns can accrue. From 1997-2007, the number of months where DFA Small Value returns exceeded 6% = 24. That is about 18% of the months in the sample. For the same timeframe, DFA Micro Cap Fund monthly performance shows that there were 27 months or a full 20% of the months where monthly returns exceeded 6%. The lesson here is that we must be in these asset classes during the quick upswings or we won't be successful in capturing the premium returns that the asset classes deliver over the long term.

“Excellent” vs. “Unexcellent” Companies

Oftentimes we have questions from clients about their interest in buying a particular individual stock because of excellent products, service, positioning etc. We are generally negative on pursuing individual stocks for this reason because there exists no real correlation between the market performance of “excellent” versus “unexcellent” companies. As we mentioned earlier, the October 2002-2007 timeframe witnessed the S&P 500 Index (which of course is just a fraction of the whole market—perhaps 15% of the total) more than doubling. To the side is a list of 10 stocks held in many portfolios and generally perceived as “excellent”.

In the 5 year long market upswing (October 9, 2002-October 9, 2007), **None** of these excellent companies outperformed the S&P 500 Index. Perhaps more interesting, we arrive at the same answer when solving for the number of these stocks that outperformed *any* DFA U.S. or international equity fund for the same time period. That's right—every DFA fund outperformed these excellent company stocks.

Housing Revisited

Without question the slump in residential home prices has taken a toll and more pain may still be ahead. Even a cursory read of popular financial literature will find a sprinkling of articles about how housing may cause the economy to collapse. A bit of perspective may be warranted. For the most part, real estate has what economists call “utility” – that is, usefulness (i.e. shelter). Most of us are not going to sell our homes if the values have declined 10% because we have to live somewhere. While housing is an important component of the national economy it does not comprise as large a percentage of the economy as one might expect. At present housing contributes about 4.5% to the whole overall economy. Exports (which have been growing at double digit rates) make up about 12% of the economy. The housing difficulties, while real and widespread will not “tank” the U.S. economy.

“Excellent Companies”

1. 3 M Corp
2. Anheuser-Busch
3. Berkshire Hathaway A
4. Coca Cola
5. Dell
6. Home Depot
7. Johnson & Johnson
8. Pfizer
9. Southwest Airlines
10. Wal Mart