

In Context

WEALTH STRATEGY FROM A DIFFERENT PERSPECTIVE

CONFIDENCE OF OUR CONVICTION

Over the past 10 years, our investments in common stocks have been a roller coaster of bull and bear markets, almost too numerous to count. The decade started off with the S&P 500 Index plummeting almost 40 percent from its peak set in early 2000, followed by a 100 percent increase through October 2007. And that was just the beginning.

If one defines a bull or bear market as a 20 percent change in value, from its 2007 peak, we have endured two more bull and bear markets *each* in the past 24 months alone! Nothing would indicate that these gyrations will end anytime soon. Yet, for most of us, it still makes sense to allocate a portion of our assets to this risky asset class.

How do we survive these never-ending swings without letting our emotions get the best of us and consume our day-to-day attention to the stock market? Ten years ago, I introduced *The Coffeehouse Investor* and three simple principles to those investors who wanted to build wealth, ignore Wall Street and get on with their lives. They are:

1. **Save for a rainy day.** Create a financial plan that allows you to determine whether you are on track to reach your financial goals.
2. **Don't put all your eggs in one basket.** Allocate your portfolio among various asset classes based on your need and ability to take risk.
3. **There is no such thing as a free lunch.** Because markets are fairly efficient, the best way to maximize your return potential is through a globally diversified portfolio of low-cost index funds.

In presenting these three principles to investors over the past 10 years, I have long advocated that the true benefit of these principles was to be found not in the bull market years, but in the bear market years. The simple Coffeehouse Investor philosophy allows one to stay committed to a common-sense investment strategy, focusing not on the things that are out of your control, like the daily ups and downs of the market, but on the timely portfolio reviews of financial plans and asset allocation, things that are in your control.

Continued on page 2

SHELF LIFE

Look at [market] fluctuations as your friend rather than your enemy — profit from folly rather than participate in it.

— Warren Buffett

Looking Beyond the Dow

Many investors view the Dow Jones Industrial Average as the total market. More accurately, it is a market index.

The Dow is 30 stocks (of nearly 6,500 U.S. stocks) chosen by Dow Jones & Company to indicate to the public how the stock market is faring. The Dow successfully measures the performance of one asset class: U.S. large-cap growth stocks. Another common tool for measuring "the market" is the S&P 500 Index, comprised of 500 U.S. large-cap companies selected by committee. It can be easy to forget the other 6,000 companies in the U.S. market and the many international companies whose stocks belong to completely different asset classes from those in the Dow.

These different asset classes can and do perform very differently over time. It takes discipline to sell asset classes that are above a target allocation (at high prices) and buy other asset classes (at low prices) to rebalance an overall plan back to the target. Rebalancing restores a portfolio to its original allocation and intended risk exposure.

David Swensen, chief investment officer of the Yale Endowment, noted "Dramatic bear markets signal the need for significant purchases of losers, while extraordinary bull markets call for substantial sales of winners. When markets make radical moves, investors demonstrate either the courage or the cowardice of their convictions."

It is crucial for investors to look beyond the Dow when thinking about markets and investment portfolios. When looking back at good and bad times, there are benefits for investors who have a globally diversified portfolio that is rebalanced regularly and based on the willingness, need and ability to take risk.

NASDAQ at 5,000: A Mistake?

By Kenneth R. French and Eugene F. Fama

Q. Richard Thaler observes, "Efficient market guys have to be willing to claim that the NASDAQ is efficiently priced at 5,000 and at 1,400. That's a tough sell." Comments?

EFF: Stock prices depend on two factors: expected profitability and the expected returns investors require to hold stocks. Both can vary dramatically through time. Thus, widely different levels of the market at different times are quite consistent with market efficiency. Indeed, they are required for market efficiency. This might well be a tough sell, but it's Finance 101.

KRF: [Thaler] is referring to the behavior of stock prices during the tech boom and bust of 1995–2001. Gene is certainly right that market efficiency requires prices to adjust to new information about future cash flows and discount rates. The critical question is whether rational expectations of cash flows and discount rates could justify the high valuations of tech stocks in 2000. With the false precision of hindsight — a behavioral bias many of us suffer — the answer seems obvious. But events are more complicated when you are living through them. Some investors were convinced tech stocks were grossly overpriced in 1999 and 2000, but others were equally certain that extraordinary growth opportunities would push prices even higher. Behavioral finance teaches us that investors tend to be overconfident about their ability to identify mistakes in the market. Given this overconfidence, and the disagreement about tech stock valuations among investors in 1999 and 2000, we should resist the temptation to conclude that anyone with any sense should have known tech prices were too high then, or that we will be able to spot such "obvious" mistakes the next time.

About This Commentary:

This question and answer was posted on August 31, 2009 as part of an ongoing series called "Fama/French Forum," hosted by Dimensional Fund Advisors. The forum features observations, research and links from economists Eugene Fama and Kenneth French. To read more, visit <http://www.dimensional.com/famafrench>.

Eugene F. Fama is a Robert R. McCormick Distinguished Service Professor of Finance at the University of Chicago Booth School of Business. Professor Fama is also chairman of the Center for Research in Security Prices at Chicago Booth. He is director of research for Dimensional Fund Advisors.

Kenneth R. French is the Carl E. and Catherine M. Heidt Professor of Finance at the Tuck School of Business at Dartmouth College. Professor French is an expert on the behavior of security prices and investment strategies. He is a director, consultant and head of investment policy for Dimensional Fund Advisors.

Continued from page 1

"Stay the course" is an oft-used and sometimes empty phrase to remind investors of the pitfalls of excessive portfolio activity in down markets. "Stay the course" takes on a whole new meaning when you embrace your investment decisions with a quiet confidence of the selections you have made and a certainty of your investment philosophy over your lifetime of investing.

Most of all, the conviction behind your investment decisions provides you the emotional freedom to ignore Wall Street and get on with your life. That's what being a Coffeehouse Investor is all about."

About This Column

A special word of thanks to author Bill Schultheis (*The Coffeehouse Investor*, 2nd edition, 2009). He graciously took time to write this quarter's main story and reflect on what it means to be a disciplined investor. The first edition of *The Coffeehouse Investor* was published in 1998, and Bill has lectured and led seminars about it ever since. Bill lives in Kirkland, Washington where he spends his free time climbing mountains, playing golf in the rain and writing about investing.

MAKING PLANS

Considering IRA Conversions in 2010

Currently, investors with income in excess of \$100,000 cannot convert their traditional IRAs to Roth IRAs. In 2010, income limits for converting a traditional IRA to a Roth IRA will be eliminated.

Which IRAs qualify? Will qualified plans such as 401(k)s and 403(b)s qualify? Investors' personal IRAs and IRAs inherited from spouses are eligible for conversion. Other inherited IRAs are not eligible. Qualified plans such as 401(k)s and 403(b)s also qualify.

Does this mean that anyone can open a Roth IRA? The rules for opening a Roth IRA are different from the rules for converting a traditional IRA to a Roth IRA. Investors who are over the income limits for opening a Roth IRA cannot open a Roth IRA. If these investors want to contribute to a Roth IRA each year, they would have to do so by converting a traditional IRA.

Can nondeductible contributions to an IRA made on an after-tax basis be converted (thus avoiding taxes)? For investors who own both deductible and nondeductible IRAs, the taxable portion of the IRA or portion of the IRA they convert will be determined based on the proportion of taxable money in all IRAs combined. The IRS does not allow taxpayers to designate that their conversions derive strictly from nondeductible contributions.

How much time is given to pay the tax bill resulting from a conversion? Only for 2010, investors converting their IRAs during this year have the option to stretch their tax liabilities over two years — paying half on their 2011 tax return and the other half on their 2012 tax return. Investors choosing this option would have these tax liabilities due on April 15, 2012 and April 15, 2013, respectively. Any conversions occurring after 2010 will have to see the resulting tax liabilities owed in the same tax year.

This information is meant to raise awareness on the topic addressed and should not be considered tax advice. It is always important to consult a tax planner before engaging in actions that may have tax consequences.

This material is derived from sources believed to be reliable, but its accuracy and the opinions based thereon are not guaranteed. The articles and opinions in this publication are for general information only and are not intended to serve as specific financial, accounting or tax advice. The opinions expressed by the featured guest authors in this newsletter are their own and may not accurately reflect those of The Buckingham Family of Financial Services. Copyright © 2009, Buckingham Family of Financial Services.