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Investment Strategy

"Be Conservative, Not Conventional!"

> Here's the paradox: the odds are overwhelming I will end up richer by aiming for a good return rather than a brilliant return – and sleep better en route. Folks who seek a killing usually get killed. Gunslingers get shot, and often in the foot, with their own guns. While there is always some guy around on a red-hot streak, his main function is to tempt the rest of us into becoming fools and paupers. A return of 15% to 20% annually is a lot more than most folks realize, or need. If a 30-year old with $10,000 in an IRA gets 15% annually, he'll be a millionaire before normal retirement. That's the power of compound interest. If that same 30-year old were to sock away another $2,000 per year at 15%, he would end up as a 65-year old $3 million fat cat. At 20%, it's an incredible $13 million. That's a lot, but it's not too much to ask. The two most definitive studies ever on long-term returns, the Ibbotson/Sinquefield and Fisher/Lorie studies, both point to average annual returns for stocks of 9% plus per year going back to the mid-1920s. So 15% to 20% per year is really 66% to 100% better than the market as a whole. That's tough but doable. Consistency is the key. It is close to impossible to get a good, long-term, rate of return if you suffer serious negative numbers en route. It's the math. A single year that is down 30% means you have to get 30% per year positive returns for the next four years to get back on track for a 15% annual average. Or, if you score 20% annually for four years, and then suffer a 30% decline, your five-year average return is only 7%.
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> . . . Ken Fisher, *Forbes,* 1989

I have often republished Ken Fisher's sage advice ever since first reading it in 1989 because it speaks to the centerpiece of my investment philosophy. To wit, "The odds are overwhelming I will end up richer by aiming for a good return rather than a brilliant return – and sleep better en route." Or as Benjamin Graham wrote, "The essence of investment management is the management of RISKS, not the management of RETURNS." Indeed, if you manage the downside the upside will take care of itself. Avoiding the big loss is, and always has been, the key to investment success. Accordingly, when the odds are not tipped in my favor I tend to not be very aggressive, a stance I took a few months ago.

Recall, it was around the end of January that, at least by my work, the "buying stampede" ended when the D-J Industrial Average (INDU/12849.59) closed lower for four consecutive sessions. Interestingly, at the "buying stampede's" intraday peak of January 26th the senior index changed hands at ~12842. At last week's intraday low it was some 131 points below that level, consistent with my statement, "Except for a few stocks, I don't see where a whole lot of money has been made since the end of January." Given that strategy, I have preferred to focus on select mutual funds and exchange-traded products with "conservative not conventional" investment styles. One such mutual fund is Goldman Sachs' Rising Dividend Growth Fund (GSRAX/$14.85), whose investment style is to invest in companies that increase their dividends by 10% per year on average for 10 years in a row. Accordingly, the fund seeks capital appreciation and current income. Another investment idea is the Yorkville High Income MLP ETF (YMLP/$19.53). YMLP is structured for an outsized current yield by investing in master limited partnerships. Yet because of that structure no tax-cumbersome K-1 is issued since the dividend distributions are classified as return of principal. Granted, my conservative stance looked pretty foolish when the INDU tagged ~13265 on April 2nd, but has not looked as foolish since then with the Dow surrendering roughly 4% into last week's lows. That declined sparked the question, "Hey Jeff, is the correction over?"

Well, as repeatedly chronicled in these comments, all of the pullbacks in the S&P 500 (SPX/1370.26) this year have been between 25 and 35 points. Accordingly, measuring from the recent closing reaction high of 1419.04 produces a level of 1394 for a 25-point correction, and 1384 for a 35-pointer. Importantly, anything more than a 45-point pullback would put the SPX below the bottom of our 1375 – 1385 support zone and thus would suggest something has changed. It would also represent a breakdown below a spread triple-bottom for most of the major averages. While there is minor support around 1360 – 1365, my hunch is that breaking below 1375 brings into view the 1320 – 1340 level. Nevertheless, coming into last week I thought the SPX would remain mired in the 1385 – 1425 consolidation zone while the short-term overbought condition was alleviated

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and the stock market's internal energy was rebuilt. And at last week's low the NYSE McClellan Oscillator was indeed back in a fully oversold position. Moreover, my daily internal energy indicator also had more than a full charge of energy. Therefore, at Tuesday's lows one should have expected some kind of "throwback rally," and that's exactly what we got. Unfortunately, Friday's Fade left the SPX back below the aforementioned 1375 – 1385 zone and consequently still vulnerable. This would be especially true if last week's lows at ~1358 are breached this week.

Since the SPX's April 2nd peak the two worst performing sectors have been Energy and Financials, which have fallen more than 5%. While this is not surprising for Energy, because that group did not act well during the entire 1Q12 rally, Financials was one of the best performing sectors of the quarter, suggesting their weakness since early April may be telegraphing a change in the investment environment. Also concerning was last week's 17% leap in the Financials' Credit Default Risk Index. Then there was market-leading Apple's (AAPL/$605.23) weakness over the past four sessions, a four-day downside skein not seen since last year. With such "tells," and given the fact that the INDU and SPX have fallen below not only their envisioned support zones, but their respective 50-DMAs, we continue to counsel for caution, believing early this week should provide better clarity on the near term directionality of stock prices. Verily, "Be Conservative Not Conventional!"

The call for this week: Earnings season commenced last week with 75% of the reporting companies beating estimates. This week will show increased earnings reports with many of the major companies reporting. Our sense is the earnings environment will continue to be pretty good, which should limit the stock market's downside to the 1320 – 1340 level. Moreover, the SPX held above its weekly uptrend chart line at 1358 last week, leaving the technical setup not as vulnerable as it was in May 2011. However, the December to late January upside runaway appears to be over until the stock market's weekly internal energy is rebuilt. Unfortunately, the weekly internal energy indicator is nowhere near being fully recharged. The implication is that the downside should be contained, but the SPX is also not likely to break out above 1425 without spending some more time consolidating.

P.S. – I am in Colorado this week and will return next week.

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