A Matter of Opinion

James B. Cloonan

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When Things Get Tough. . .

"When things get tough, the tough get going." This phrase, which is heard much too often these days, is nevertheless an adequate description of the actions of many of society's achievers. While this description may apply to the acknowledged captains of industry, political leaders, military heroes and "coaches of the year," the reverse is most likely true for individuals who manage their own investment portfolios.

In following a long-term investment strategy, many investors are surprised to find, for example, that overall long-term portfolio returns are a function of how well the portfolio performs in strong bull markets. However, many investors tend to relax during periods of favorable stock market performance and work vigorously in an attempt to generate favorable returns during somnambulant market periods or during downward market trends. It's easy to relax in periods of escalating stock prices merely because things are so rosy. During other markets, we are inclined to remember that "when the going gets tough, the tough get going."

I offer a substitute cliche. It too is used often and is well worn but is much more applicable to the portfolio manager. "Make it while you can." Consider a properly-diversified, well-managed, long-term growth oriented portfolio of common stocks which has attained an annual rate of return of 13% over the long-run. This return compares quite favorably with a long-term S & P 500 Stock Index return of 9% annually. If portfolio performance, say, over a four year period were decomposed to annual rates of return, we might see the following relationship to the S & P.

Year	1	2	3	4
S & P	+22%	-12%	+6%	+20%
Growth Portfolio	+36%	-14%	+4%	+26%

This type of pattern, in fact, emerges in studies of the so-called "small stock effect" which I have discussed in several previous "Opinion" columns. The message that ultimately must emerge is that there is not much that can be done to improve portfolio performance in weak markets — except to decline to participate. However, superior long-run portfolio returns are generally derived by substantially outperforming the market in good times. Quite often, however, investors are blinded by their portfolio's absolute returns during bull markets. The additional returns which could have been earned through the application of a little more effort are often overlooked.

If we consider the "best year" returns in the above example, a passive approach to portfolio management would have earned a 22% return, which is the market rate of return. It is quite easy to see where such investors might think that they are doing "well enough" and reduce their efforts to outperform the market. However, it is times such as these that generate the opportunities for long-run success. Therefore, we should actually increase our investment management efforts. Most likely, current stock market conditions will prevail for a few more years. It is imperative that investors manage their portfolios very carefully during the high yield portion of the market cycle.

Let's turn our attention for a moment to the other leg of the market cycle. If, during market downturns, we lose eight to ten percent of invested capital (allowing for dividend returns), we tend to get depressed. We should not. The market is always going to react to business and economic cycles and long-term investors should measure their performance relative to broad market averages. A properly diversified, long-term, growth oriented portfolio can be expected to perform a little worse than the market during adverse market conditions and should perform substantially better than the market during boom periods.

While short-term gyrations are not important to long-term investors, it is probably a good idea for such investors to evaluate their portfolio performance on an annual basis through comparison with the yields (growth and dividends) of a broad market index. In this way, investors can obtain insights into their performance (and management skills) during upward, downward and laterally moving markets.

One retort to all of this might go something like this. "Since I don't live on relative portfolio yields, not losing very much (relative to the market) during bad times isn't very encouraging." However, on the assumption that stocks in general will provide positive yields over the long-term, relative yields actually become absolute yields. If you feel that this assumption is invalid, then you shouldn't be in the stock market in the first place.

I suggest very strongly to those of you who manage your own stock portfolios, that you generate annual reports similar to the ones you would expect to receive from a professional manager. These reports should contain dividend yields, realized and unrealized gains (losses) and a composite yield based on the average investment in the market over the year. Reports such as these develop a sense of accountability and serve to point out management strengths and weaknesses. The goal, of course, is better portfolio performance in the future.