# Investment Directions

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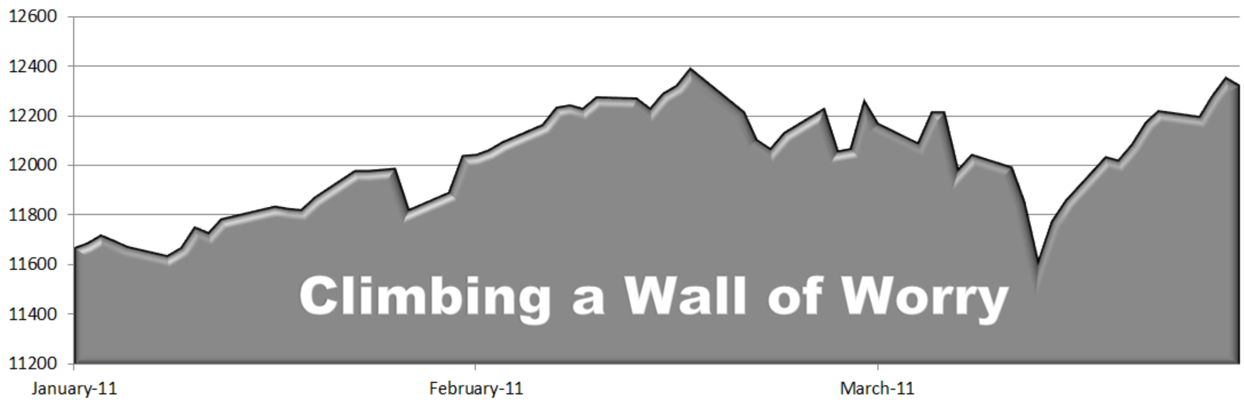


An old Wall Street Proverb says "A bull market climbs a wall of worry." Surely this was never more true than in the first quarter of this year. It was one of the best quarters in the past twenty years[1] despite many worrisome world events.

Japan was rocked by a powerful earthquake, wars raged, oil rich countries experienced violence and long-standing leaders were deposed. Here at home, heavy snow fell in the East, politicians fought to avoid a government shutdown and energy prices rose.

Despite it all, the value of America's great companies increased.

As we look forward, although the snow has melted we still have plenty to worry about: Is a nuclear plume headed for the West Coast? Will the Middle East be taken over by extremists? Who will win Dancing with the Stars?

## Why we are Where we are

It seems there is no shortage of things to worry about. In my nearly thirty years in this business I have seen troubles at home and abroad, startling innovation and shocking weakness in high places. And yet, America's great companies find a way to push ahead and make money.

It is the profits earned by these great companies that are propelling this rebound. On Wall Street profits or earnings often impact a company's value.

Early this year American companies reported their results for the end of last year. Almost three fourths of the companies in the S&P 500 reported better-than-expected earnings for the fourth quarter of 2010. More than half beat their expected revenues in the quarter. That is remarkable and is why we are where we are.

## What lies ahead?

If I knew precisely what was going to happen in the future we could all make a lot of money. While I do not enjoy that kind of economic foresight, I do have an opinion … ok, I have several opinions:

I expect volatility to continue. I expect inflation will eventually return and will push interest rates up slowly. I expect home values will rise with inflation but higher interest rates may keep them from moving rapidly upward. I also expect stock values may move higher over time; although the ride may be rough I believe the expansion that started two years ago in March has a ways yet to go.

[1] *Graphic above illustrates the Dow Jones Industrial Average, an unmanaged index of 30 large U.S. stocks which does not accommodate direct investment. Based on 12/31/2010 value of 11,577.51 and 3/31/2011 value of 12,319.73, the index gained over 6% for the quarter.*

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# Rules to Live by

I believe in gleaning wisdom wherever I can find it and successful people are a good source. Recently I read that Jack Welch, who delivered a 23 percent compounded annual shareholder return over his 20-year tenure as CEO of General Electric, had six rules to guide his organization.

When I read those six rules I thought they could be applied to life – I present them here for your consideration.

1. Face reality as it is, not as it was or what you wish it to be.

2. Be candid with everyone.

3. Don't manage…lead.

4. Change before you have to.

5. If you don't have a competitive advantage, don't compete.

6. Control your own destiny or someone else will.


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LET'S TALK ABOUT…

# MEMORIAL DAY – A REMEMBRANCE

During the desperate days of the Battle of Britain, hundreds of Americans crossed the border into Canada to enlist with the Royal Canadian Air Force. Knowingly breaking the law, but with the tacit approval of the then still officially neutral United States Government, they volunteered to fight the Nazis.

John Gillespie Magee, Jr., was one such American. Born in Shanghai, China, in 1922 to an English mother and a Scotch-Irish-American father, Magee was 18 years old when he entered flight training. Within the year, he was sent to England and posted to the newly formed No 412 Fighter Squadron, RCAF, which was activated at Digby, England, on 30 June 1941. He was qualified on and flew the Supermarine Spitfire.

Flying fighter sweeps over France and air defense over England against the German Luftwaffe, he rose to the rank of Pilot Officer. On 3 September 1941, Magee flew a high altitude (30,000 feet) test flight in a newer model of the Spitfire V. As he orbited and climbed upward, he was struck with the inspiration of a poem — "To touch the face of God." Once back on the ground, he wrote a letter to his parents. In it he commented, "I am enclosing a verse I wrote the other day. It started at 30,000 feet, and was finished soon after I landed." On the back of the letter, he jotted down his poem, 'High Flight.'

## *High Flight*

Oh! I have slipped the surly bonds of earth
And danced the skies on laughter-silvered wings;
Sunward I've climbed, and joined the tumbling mirth
Of sun-split clouds - and done a hundred things
You have not dreamed of - wheeled and soared and swung
High in the sunlit silence. Hov'ring there
I've chased the shouting wind along, and flung
My eager craft through footless halls of air.
Up, up the long delirious, burning blue,
I've topped the windswept heights with easy grace
Where never lark, or even eagle flew -
And, while with silent lifting mind I've trod
The high untresspassed sanctity of space,
Put out my hand and touched the face of God.

*Pilot Officer Gillespie Magee*
*No 412 squadron, RCAF*
*Killed 11 December 1941*
*Source: www.skygod.com*

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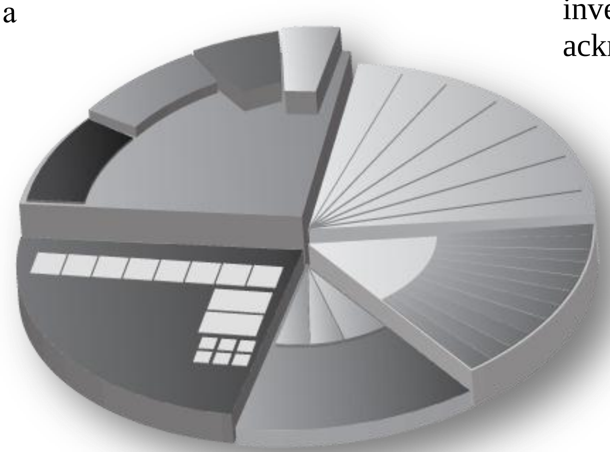
## Purposeful Diversification

Looking back at the big stock market declines in 2000 and again in 2008, many wonder if there isn't a better way to invest. Articles have been written and pundits have proclaimed that diversification just doesn't work anymore.



That is natural, both downturns were painful. It may not surprise you to learn I disagree with the pundits and still believe in what we call "Purposeful Diversification." [1]

With 20/20 hindsight it is easy to find an investment, fund or company which through luck or skill weathered the storm well. Monday morning quarterbacks are quick to say the performance of Acme Pipe Threaders Inc.,(or some other investment which did well but could not have been known in advance) proves diversification is dead.

## Volatility vs Risk

The critical point ignored by some is that investing involves risk. Some in our industry are afraid to use the "R" word and instead use the word volatility, but volatility is different.

Good volatility is not risk, it is unexpected gain. Bad volatility is risk, it is unexpected loss. The key word here is unexpected; it was the rapid and unexpected drop in values that made 2000 and 2008 so unsettling.

Pundits tend to focus on return and ignore risk so any drop in value is unexpected. That is foolish of course but it is what makes pundits different from investors. Wise investors acknowledge risk and plan for it.

## Addressing Risk

A lesson might be learned from the huge retirement plans at America's great companies. These plans are governed by a law called the Employee Retirement Income Security Act, or ERISA. According to ERISA, fiduciaries in these plans must address the risk of "large losses" by diversifying.[2]

What ERISA recognizes and most investors understand is that broad diversification may limit exposure to risks inherent in concentrated investments.

Imagine investing in a portfolio of thousands of stocks versus concentrating your investment in just one company. Owning any single company exposes you to potentially greater financial impact due to the health of the CEO, a natural disaster near the headquarters or a misstep by management or workers.

While taking on such risks can sometimes be rewarded, in my opinion, serious, long-term investors are better served by purposeful diversification that is both broad and deep than by betting heavily on a concentrated position.

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[1] Diversification does not assure against loss.

[2] ERISA Section 404(a)(1)(C).

Pie Chart Source: AmericanDigest.org