

EPIC ADVISORS, LLC

Weekly Market Commentary

August 13, 2008

Sean Hannon, CFA, CFP

By nature, investment capital seeks return. Our goal is to accumulate wealth through investment decisions. There are two ways to do so. The first would be to make massive gains in a quick manner. However, with this search for quick gains, the risk of loss naturally increases. Since losses are emotionally difficult to handle and reduce the capital we need to generate future gains, a high risk trading strategy should be followed by the few whose personal circumstances can allow for such a venture.

The second, more standard approach is to follow the path of compounding. Under a compounding program, we aim to generate consistent returns, reinvest the gains into our portfolio and then earn income off an ever increasing capital base. As the capital base rises, the dollar gain increases tremendously. Running a compounding program for years offers a path that is powerful, predictable and easily understandable.

This appears to be a simple answer. All you need to do is pick a rate of return, plug it into a financial calculator, check back in twenty years and start spending your gains. The average financial advisor will use this approach to manage their client's money. Using compounding tables and the long-term average of US equity market returns, financial advisors devise plans where a client can earn 8% per year and achieve all of the predetermined goals. The advisor takes the money, invests in index funds, pockets a fee and hunts for the next client. That is pretty good work if you can find it. What most do not realize is the analysis is incredibly sensitive to rates of return. Any variance to the return number plugged into the calculator causes major differences.

As an example, assume you invested \$10,000 and expected to earn a consistent 8% per year for each of the next 20 years. At the end of 20 years, your initial investment would have grown to \$46,610. If the return actually was 7%, your investment grows to \$38,697 – 17% less than planned. Most people would not be upset about their investment missing its target return by 1%. After all, you still made money and the dollar loss in the first year is only \$100. Even if we miss every year, it would only be \$2,000, right (\$100 per year * 20 years)? Wrong. The success of compounding arises because the equity base grows and dollar returns increase. A seemingly insignificant 1% return miss reduces your expected net worth by 17% at retirement. For most, this is a material miss that will cause them to rethink their plans, postpone retirement or make life altering decisions.

If a 1% miss causes so much pain, how about a dramatic miss? As mentioned earlier, the typical advisor will assume somewhere between an 8-10% annual rate of return based on long term market assumptions. By trying to get you to focus on the long term, they can use these rates and then explain

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away poor performance as a need to wait out down periods and focus on the future. For investors during the 1990s, this approach appeared overly conservative. As the market routinely generated double digit gains, the 8-10% benchmark was achieved and the advisors appeared brilliant.

Recent history has not been as kind. With the S&P 500 currently trading at 1,289, the index is at the same level as January 1999. In nearly 10 years, an investor purchasing the S&P 500 index fund for broad market exposure has made no money. Anyone who invested \$10,000 in 1999 with an 8% return assumption would expect to have \$21,589. Depending upon fees, they are most likely in negative territory. To achieve their initial goal, this investor would need to earn nearly 17% per year for the next 10 years. While this rate of return is achievable, I do not think a passive index exposure will get there.

If the long run return is 8% and the S&P 500 has not moved for ten years, won't mean reversion ensure higher return over the coming years? This argument is logical, yet flawed. On October 10th, 1928, the Dow Jones Industrial Average (DJIA) closed at 353. On September 16, 1954 the DJIA closed at 353. This was a period of 27 years with no change in the index. In January 1964, the (DJIA) traded at 785. In April 1980, the DJIA changed hands at 785 – no return over 17 years. Looking at history, many years of no movement in the broad market are not unprecedented. They have happened before and will happen again. What makes today more risky is that many investors have their futures tied to broad index movement of domestic and international equities.

With such a sobering view of how missed estimates can derail a compounding plan, two main questions arise. The first is are we entering a prolonged period of flat market returns (we have already gone 10 years with no movement in the S&P 500) and what can be done to earn return on our money.

Personally, I think the next 3-5 years in the market will be very difficult. The world economy has morphed into a mechanism that is highly depended on borrowed money and cheap access to capital. As the credit markets continue unwinding, interest rates have been lowered. However, banks have reacted in typical fashion and are punishing today's borrowers for yesterday's sins. Banks have tightened credit to all and made the ability to fund consumption via new debt extremely difficult. With the debt spigot off, consumption and investment will drop. Going forward, it will be hard for the economy to generate incremental growth and for companies to garner the investment that is needed to innovate. The end result will be strong companies in leading industries will have the internal cash flow and access to capital that is needed to grow. This will allow these companies to increase their economic moat and dominate their respective industries. Weak companies will not have access to capital, will see their competitive positions eroded and will fade into history. Within this environment, some companies do well, others

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will do poorly, yet the broad market will not move materially higher (in fact I think the more likely outcome is more losses for the broad market). Therefore, a heavily weighted index position will ensure low growth and high frustration.

To make money in such an environment, the value of solid research will be accorded a premium. As markets routinely thrash with no direction, good and bad companies see their stock prices rise and fall in tandem. By having the knowledge of what each company is worth, we buy the companies who are inexpensive and well positioned in their industry, short the overvalued companies who are destined to fail and reap the benefits. By actively searching for new ideas, we create a universe of stocks that offer the ability to generate return regardless of market direction.

Using this thinking, we have made a significant change to our portfolio management approach. Typically, we focus 50% of our portfolio on our research and then a combination of index funds and various trading ideas to round out our exposure. Assuming the broad market will be flat for years to come, we are now allocating 70% to our best research ideas, removing index exposure and focusing the remaining portfolio on our best trading ideas. Taking this approach will allow us to leverage the ideas we feel have the most profit potential and avoid committing capital to parts of the market that will not pay a decent rate of return.