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NEWSLETTER

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NEWS OF PEABODY RIVER

The first half of 2008 was, for this firm, a time of consolidation and settling down to routine business after the excitement of creation. Peabody River acquired its first client, and I have found myself in the position of a seasoned investment manager advising others on how to set up as an independent registered investment adviser. I have also been pursuing a special research interest of mine: the economics of collecting. Don't misunderstand me: I consider collectibles to be poor investments, despite what you may hear from time to time about the tremendous prices realized in auctions of art or wine. But collecting can be a wonderful use of discretionary income, and collectibles are assets. I have been following up my personal interest in old books and maps by trying to understand collecting from an investment standpoint. Not much has yet been written about this by anyone, except for some puff pieces and a few academic articles on the market for fine art. I have been composing a long article on this topic for publication. You will be hearing more from me about this.

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BRIEF REVIEW OF THE FIRST HALF OF 2008

Like other investment professionals who have spent considerable time thinking about the risk of investments, I can be a little sanguine about the past six months' ordeal in the market. We understand what can happen. But this recent sharp decline is very painful for many investors. For those who were counting on having their nest eggs available for consumption starting this year, the pain is in no way illusory, and the market drop requires difficult choices and changes of plans. The S&P 500 index had a return of -11.91% for the first half of the year, and -8.43% for June alone. The last time we had a worse June and a worse first half was 2002.

Peabody River Asset Management's composite return for the first half of the year was -9.47%, dismal, but ahead of the market. You should be aware, though, that our portfolios are heterogeneous. Because they are managed to different objectives, they can be expected to have different returns.

If you look at the returns of the Vanguard mutual funds, you will see that their S&P 500 index fund had a (compound) return over the 10 years ending in June of 2.81% per year, whereas their Prime Money Market fund had a return over the same period of 3.62%. (These are both real investments whose returns are net of fees, unlike indexes.) During that time, inflation compounded at a rate of approximately 2.45%. U.S. stocks, taken as a whole, were not the place to invest for the last ten years.

As I've said before, I don't make short-term forecasts of the market, but I do have a long-term outlook, and I give that expectation again at the end of my commentary article, below. Lately, I've become intrigued by prediction markets, like the University of Iowa's Iowa Electronic Markets and Intrade. These are like stock markets, but the securities that trade on them are contracts on the outcome of various events, like presidential elections. (There are fine, readable articles on prediction markets in *Wikipedia* and the March 2008 issue of *Scientific American*.) As of the close of trade on 30 June, the contract on Intrade for a recession in the U.S. in 2008 implied a 25% probability. This is worth contemplating, but it's not a forecast of the stock market, which is already impounding this outlook. In a sense, the stock market is its own forecast of itself. But that's a controversial statement that I'll explain in a later commentary essay.

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ESSAY: HOW TO THINK ABOUT INVESTMENT RETURNS

I was reading an instruction book for backpackers a few years ago. The author emphasized the importance of carrying a light load, which makes sense, but I was brought up short by his discussion of how to choose a magnetic compass. He referred to one model that had a number of features and weighed one ounce. Then he described another, simpler model that weighed only 0.8 ounces. "This is just 0.2 ounce lighter," he wrote, "but that's still a 20-percent weight saving."

This is completely backwards! He should have written, "That may be a saving of 20 percent in weight, but it's a difference of only 0.2 ounces." A shaggy backpacker might lighten his load the same amount by just getting a haircut. And a consideration of why the original statement is wrong provides a lesson in how to think about investment returns.

A backpacker carries weight, not percentages on his back. An investment produces money or increased value, not percentages. We use percentages to express relative values. An investment that has a return of 20% is one fifth larger than its original value. If the original portfolio was worth $1,000,000, then most people would agree that the increase of 20%, or $200,000, was real money. In contrast, if that original portfolio was worth $1, the added 20 cents wouldn't make even the poorest citizen of the United States feel much better off.

A backpack is a kind of portfolio, a collection of utilities that a hiker might need or want during his sojourn in the wilderness. And an investment portfolio, of course, is a collection of varied investment vehicles, like stocks, bonds, mutual funds, money market funds, and so forth. (I concede that, like all analogies, this one is imperfect; it begins to break down when you realize that, all else being equal, a backpacker prefers *less* weight, but an investor prefers *more* money.) Now, if the hiker can shave 20% off the weight of every item in the pack and the pack itself, then he's carrying 20% less weight, and that's a substantial improvement in his well-being.

What matters for the investor is the total package, the entire portfolio. A change in one component of the package, considered in isolation, often matters very little, unless it is indicative of something systematic.

So, if my ability to reduce the weight of my compass by 20% were indicative of an ability to reduce the weight of every other component of my backpack by 20%, then I might be grateful for the knowledge that I could save the 0.2 ounces. But, in actuality, my ability to shave 0.2 ounces off the weight of my compass is indicative of nothing.

If what really matters is the value of the portfolio, not the return, why do we talk about returns at all? Because returns allow us to compare changes in investment value along two dimensions: across time, and across different kinds of investment options (which options include not just stocks, bonds, mutual funds, and so forth, but also investment managers and even inflation).

Across time, we compare the series of returns generated by an investment vehicle minute after minute, month after month, year after year. Most investments fluctuate in value quite a bit, some much more than others, so a single observation of return (for one day, or one month, or one year) tells us little about what is happening and little about what we might expect. The patterns and averages over time, however, can be informative, as long as one bears in mind that no supreme authority guarantees that the future will be like the past.

Across investment vehicles, and across investment managers, we can make comparisons of results in a given period, and over a span of periods, like, say, the last decade. If an investment manager can pick a stock that increases 20% in value in a given span of time, this is of little interest unless it is indicative of her overall ability to pick stocks that increase in value within a period of time, and over multiple periods of time.

Investment managers, professional and amateur alike, delight in talk of their successful investment picks. But what is a man profited, if he gain returns, and he loses net worth? Few, however, can keep this thought at the fore for any length of time; hence the cynical but trustworthy maxim for anyone selling investment advice: talk about your winners.

That is one way to mislead investors about returns, but there are other tricks of the trade. One of the simplest is to confound yield with return, and to boast of the former without regard to the latter. Only in special circumstances are yield and return are the same thing, and usually, they are not. "Yield" is the income thrown off by an investment vehicle, expressed as a percentage of the price of that investment vehicle. For example, if a stock that is priced at \$50 pays an annual dividend of \$2, then it has a dividend yield of 4% ($=\frac{\$2}{\$50}$). And if—and only if—the stock begins and ends the year at that same price of \$50, the return on the stock for the year will also have been 4%. But what if the stock's price began the year at \$50 and falls to \$40 at the end of the year? In that case, the dividend yield actually went up (because at the end of the year, it takes only $40 rather than $50 to generate the $2 dividend), but the investor in that stock lost a net value of $8, because of the price decline. The stock in this case had a negative return. In short, yield is only one of two components of the total return, and not even necessarily the most important component. Uncle Sam, you can be sure, is never confused about the two components of return. He taxes income and long-term price increases (capital gains) at separate and distinct rates (though, since the Economic Growth and Tax Relief Reconciliation Act of 2001, these are for stocks usually and for the time being the same rate). This means that, if an investment has both yield and a price return, taxes lower your total return when the pre-tax return is positive, and they may also lower your return *even when* the pre-tax return is negative, because yield by itself is always positive. This is one reason (among several) that an investment manager should be dedicated to achieving good after-tax returns of a taxable portfolio, not pre-tax returns.

Investment managers have not been above taking advantage of investors' confusion of yield with return. Nearly twenty years ago, a well-known mutual fund company was promoting a government bond fund (normally considered a safe investment) with "enhanced" yield. The only way to enhance the yield, though, was through the execution of a strategy that the manager believed to be "safe," but which was not. He was making a bet on interest rates that turned out to be very wrong. In order to keep the investors happy, the fund continued to pay out its high "yield", but these payments weren't yield; they were actually payouts of the principal of the fund. Returns were negative.

Returns can be slippery. They are essential as indicators of past performance and for framing expectations for the future, but they must be interpreted with care. In the end, what matters for your well-being is not the return you realized, but the value of your portfolio.

But this is all talk of returns in the abstract. What are the numbers, the returns you can realistically expect for stocks, bonds, and investment portfolios generally? Those will be the subject of a later commentary. But I've already written that my view is that we can expect, over the long run, that the U.S. stock market will have a total return of 7% to 8% per year on average (before subtracting the effect of inflation).

Before considering those numbers, though, we need to think hard about investment risk, the subject of my next essay.

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