



FOCUS POINTS

“...needless risk is correlated with greed, not returns...”

We started the year affirming our optimistic outlook for the economy and the markets in 2007 and do so again, now. We are still **positive on stocks** and think **stocks are much more attractive than bonds**. In our bond portfolios, we are maintaining an **above average duration**. Since none of this represents a change and the markets have been volatile, this seems like a particularly useful time to add to the numerous pieces we have written on risk.

Correlating risk with return.

For years academicians have struggled to show that above average returns are more the result of above average risk-taking than clairvoyance. Most investors are unhappy to express the idea that way. Somehow it is much more invigorating to acknowledge that “if you want higher returns, you take more risk.” Since everyone wants higher returns, we all need to take more risk, until...

Sadly, the history of the markets is replete with examples of investors taking more and more risk and getting... more and more risk, but not higher returns. It is only after a period of a **negative correlation** between risk and return that some see the folly of having taken **needless risk**. We believe **needless risk** is correlated with greed, not return; some investors are so hungry for higher returns that they ignore important elements of risk. And, as Warren Buffett has said, “The five most dangerous words are: Everybody else is doing it.”

Needless risk there for the taking.

As we look at the markets we see countless examples of **needless risk** being taken, enthusiastically, by some investors in the pursuit of higher returns.

In the bond market, interest rates around the world have fallen to levels that can only be rationalized by a protracted period of low inflation, yet there is no coordinated discipline among the world’s central banks to limit the growth of money. If anything, the willingness to run the printing presses faster whenever “necessary” seems more prevalent.

Within the domestic bond market, many have an almost total disregard for credit quality in

building portfolios. Currently, there is a “problem” in the mortgage market caused by increasing defaults, but other market sectors where investors are being offered minimal incremental returns for greater credit risk may also have a problem later in the cycle.

Former Fed chairman Greenspan chose to provide excess money when the chips were down. If Bernanke instead fears degrading all U.S. debt by flooding the market with excess money after the next crisis and chooses a different tact, many high risk investors are going to face massive losses.

The message seems clear: *Take little or no credit risk; seek excess return by adjusting the portfolio’s duration in anticipation of changing economic outlooks.*

In the stock market there has also been a global pursuit of higher returns, with little concern for the risk being shouldered. We are seeing serious money, money that could not be easily replaced and possibly needed on short notice, piling into untested emerging markets, illiquid private equity funds and purposefully opaque hedge funds. These investors are willing to take on much greater risk because they believe that they will be able to get their money when they want it and earn an attractive profit. Maybe, maybe not!

Even in the sector of the U.S. market where we concentrate most of our effort, large capitalization stocks, there seems little differentiation in valuations of fast and slow growing companies, high and low yielding companies, AA and BB companies, etc.

The message again seems clear: *Invest the majority of one’s assets in financially sound, high quality companies; seek excess return by favoring stocks that are highly liquid and well priced for the company’s growth, relative to other comparable companies.*

We constantly consider the potential risks and rewards of the securities in our portfolios, seeking attractive returns with the highest probability. Our experience is that this is the path to exceptional long-term returns.