

This letter is dated October 2006

Doubt is not a pleasant condition, but certainty is absurd.

- Voltaire (1694 - 1778)

Uncertainty causes stress. Particularly when it relates to important issues like health, family or financial well-being. Given the anxiety and fear that arises from uncertainty, it should come as no surprise that investors are eager to eliminate financial risk. The fundamental problem is that there are many types of risks and it is impossible to eliminate all of them. Investors should understand that attractive opportunities are often found where risk is perceived to be highest.

Investors focused on one risk factor are vulnerable to making bad decisions. A successful salesman once told me that the key to his success was identifying what a potential customer was most afraid of and then recommending something that protected them from it. He claimed it was the quickest route to closing a sale. While I agree this may be an effective sales tactic, it can also lead to bad decision making, especially when investing. A preoccupation with one type of risk can cause investors to unwittingly take on other significant risks because they fail to take into account the full picture.

Investors are particularly susceptible to developing a myopic focus on a specific type of risk that recently caused big losses. For example, after the tragic events of 9-11 many investors concentrated almost exclusively on the risks posed by more terrorist attacks while other risks received little if any attention. Peter Lynch referred to this common error as “penultimate preparedness” in his bestselling book One Up On Wall Street. To dramatize the danger of this backward-looking mentality Lynch shared the following from Mayan mythology:

The universe was destroyed four times, and every time the Mayans learned a sad lesson and vowed to be better protected—but it was always for the previous menace. First there was a flood, and the survivors remembered it and moved to higher ground into the woods, built dikes and retaining walls and put their houses in the trees. Their efforts were for naught because the next time around the world was destroyed by fire. After that the survivors of the fire came down out of the trees and ran as

far away from woods as possible. They built new houses out of stone, particularly along a craggy fissure. Soon enough the world was destroyed by an earthquake.”¹

Lynch could not remember the 4th disaster but I think the point is clear. This tendency to let the last nemesis dominate big decisions is by no means unique to the Mayans and is an instinct that investors should guard against.

I had an experience several years ago that serves as a good illustration of the financial danger posed by such myopia.² In 1990, a client referred me to an attorney who was nearing retirement and in need of investment advice. The attorney’s portfolio, worth about \$3 million at the time, was invested almost entirely in money market securities and short-term certificates of deposit (CDs). In our initial meeting I listened and took notes as the attorney described his financial position, goals and aversion to what he called principal risk. In our second meeting I proposed a mix of cash equivalents, fixed income and equities. After taking less than a minute to glance over my recommendations, the attorney launched into a lecture on the importance of protecting the principal value of his assets during his retirement.

He reasoned that he could generate more than \$200,000 a year on his \$3,000,000 without taking any “risk” simply by investing in CDs. My recommended portfolio produced an income of just over \$100,000 (a little more than he needed to meet expenses) and, as he pointed out, “only God knows how much it will be worth in 12 months”. He ended our conversation by telling me how tired he was of worrying about money and how several of his friends lost a great deal of money in the 1987 stock market crash. He was not about to risk any of his hard-earned retirement money in “the market”. He added that stocks had fallen over 10% in the previous two months.

As you might expect, we did not have a third meeting but I have often wondered just how much worrying he has done during the years since our 1990 meeting. If he stuck with his “worry-free” strategy—100% short term CDs and money market securities, his income declined more than 75% over the following 13 years as short-term rates declined from over 7% in 1990 to under 2% in 2003.³

I share this story not to imply that CDs and money market securities are bad investments, but rather to point out the danger inherent in not considering the risk/reward tradeoff associated with a specific investment or investment strategy. The truth is that all investments and all investment strategies have inherent risks or “downsides”. By investing exclusively in short term CDs and

money market securities the attorney, perhaps unintentionally, assumed a high degree of reinvestment risk. If short term rates happened to go up in the ensuing years and he stayed with the same strategy, his income would have increased nicely. However, they actually went down resulting in significantly reduced income.

Investors concerned about the effects of falling interest rates can reduce reinvestment risk by buying long term bonds but this strategy exposes the investor to the risk that inflation and interest rates increase and their income does not. To make matters worse, the market value of long-term fixed rate investments declines as rates rise. For example, a 15 year 5% bond would decline about 10% in market value for every 1% increase in rates. In addition, if the bonds are not backed by the Federal Government investors face another danger-- the risk that deterioration in the issuer's financial condition causes the bond's price to fall.

Given the many risks associated with fixed income investments perhaps stocks are the better choice. After all, dividends on blue chip stocks are rarely cut and actually increased at an annual rate of 5% during the second half of the 20th century.⁴ But stocks expose investors to a myriad of other risks that can result in losses—so many risks that I cannot come close to offering an all-inclusive list. For instance, equity prices can fall because of macroeconomic factors, political turmoil and company specific problems to name just a few.

Since bonds and stocks pose risks perhaps real estate is the answer. After all, you cannot make any more land as the saying goes. However, real estate is not immune from risk either. Real estate prices are affected by many difficult if not impossible to predict variables as well such as interest rates, economic conditions, supply and demand, tax rates and more.

Perhaps commodities such as gold or oil offer a solution. Gold has been valued by civilizations for thousands of years. It has also been a great investment recently, shooting up over 25% in the last 12 months and more than 100% over the last 5 years. But the same could have been said in late 1979 before gold's 50% decline and 20 year bear market.⁵ Perhaps oil is the only "sure-thing" today. After all, demand for oil is growing while remaining supply is declining. Yet that was also the popular view in 1979 just ahead of a 60% decline in the price of crude and essentially a 20-year bear market in oil.⁶ I am not suggesting that history will simply repeat itself, I am only making the observation that oil and gold are far from "sure things".

The point of citing all of these examples is not to “knock” various investment options, but rather to highlight that each has a real potential to disappoint. More to the point, an asset’s real risk is often highest when its perceived risk is lowest. This results from the fact that an asset’s price is typically high when investors see little risk in owning it. For example, in 1999 investors generally perceived large capitalization technology stocks as having little risk and great profit potential. It is evident in retrospect that the real risks were actually quite high. Conversely, commodities and real estate, two asset classes that were widely perceived as having higher risk and having little profit potential in 1999 have performed very well since.⁷ Market history is full of cycles that go from high perceived risk and low prices to low perceived risk and high prices. Investors who take advantage of these cycles are likely to outperform investors that are consumed by the perceived big risk of the day. Of course this is easier said than done given that emotions are usually pushing the wrong way.

Current bond prices suggest most investors are not very concerned about interest rate risk. This is reflected by the fact that long term treasury bonds pay lower interest rates than their short-term counterparts.⁸ Investors appear more concerned about reinvestment risk than interest rate risk at the moment. I am concerned about both risks and therefore favor a short-term laddered approach staggering maturities out three to 5 years.

Fixed income investors do not appear to be overly worried about credit risk either as evidenced by the historically small interest premiums paid by lower quality issuers.⁹ The risk of bond defaults appears low based on market prices but the real risks may be higher. In the current environment of credit confidence I favor bonds backed by the highest rated issuers.

Current equity prices reflect a very different view of risk than they did in 1999. Several blue chip public companies are trading at prices less than half of what they were six years ago despite significantly higher profits.¹⁰ Bill Miller, a highly successful portfolio manager, recently told Outstanding Investor Digest that “one of the markers, in (his) opinion, of a high future return is where the worst rate of return has been during the preceding five or six years.”¹¹ It seems that few things create more doubt among investors than years of poor performance. I think that the current lack of confidence in select blue chip stocks may present an opportunity for investors. Certainty does not exist in the financial markets or in life. However, opportunity does and it is often found in unpopular places.

Phil McCauley
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¹ Lynch, Peter. One Up on Wall Street. New York, New York: Penguin Books, 1989. 76.

² This example is for illustrative purposes only. Past performance is not a guarantee of future results.

³ <http://www.federalreserve.gov/releases/h15/data.htm>

⁴ <http://www.safehaven.com/showarticle.cfm?id=871&pv=1>; Robert Shiller Data, Standard & Poors

⁵ <http://www.kitco.com/charts/historicalgold.html>

⁶ <http://www.wtrg.com/prices.htm>

⁷ http://bigpicture.typepad.com/comments/2005/10/interview_with_.html

⁸ <http://www.bloomberg.com/markets/rates/index.html>

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Investing in commodities entails significant risks. Commodity prices may be affected by a variety of factors at any time, including but not limited to, (i) changes in supply and demand relationships, (ii) governmental programs and policies, (iii) national and international political and economic events, war and terrorist events, (iv) changes in interest and exchange rates, (v) trading activities in commodities and related contracts, (vi) pestilence, technological change and weather, and (vii) the price volatility of a commodity. In addition, the commodities markets are subject to temporary distortions or other disruptions due to various factors, including lack of liquidity, participation of speculators and government intervention.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

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