

"Be Conservative Not Conventional"

"Here's the paradox: the odds are overwhelming I will end up richer by aiming for a good return rather than a brilliant return – and sleep better en route. Folks who seek a killing usually get killed. Gunslingers get shot, and often in the foot, with their own guns. While there is always some guy around on a red-hot streak, his main function is to tempt the rest of us into becoming fools and paupers. A return of 15% to 20% annually is a lot more than most folks realize, or need. If a 30-year old with \$10,000 in an IRA gets 15% annually, he'll be a millionaire before normal retirement. That's the power of compound interest. If that same 30-year old were to sock away another \$2,000 per year at 15%, he would end up as a 65-year old \$3 million fat cat. At 20%, it's an incredible \$13 million. That's a lot, but it's not too much to ask. The two most definitive studies ever on long-term returns, the Ibbotson/Sinquefeld and Fisher/Lorie studies, both point to average annual returns for stocks of 9% plus per year going back to the mid-1920s. So 15% to 20% per year is really 66% to 100% better than the market as a whole. That's tough but doable. Consistency is the key. It is close to impossible to get a good, long-term, rate of return if you suffer serious negative numbers en route. It's the math. A single year that is down 30% means you have to get 30% per year positive returns for the next four years to get back on track for a 15% annual average. Or, if you score 20% annually for four years, and then suffer a 30% decline, your five-year average return is only 7%."

... Ken Fisher, *Forbes*, 1989

I was reminded of Ken Fisher's cogent comments from his 1989 *Forbes* article as I perused Berkshire Hathaway's annual shareholders' letter over the weekend. The "memory jog" came while examining Berkshire's stock market performance. Sure enough, since 1965 the S&P 500's compounded annual gain (including dividends) was ~9.3% for a compounded return of 5,430%. Over that same timeframe Berkshire's annual compounded return was 20.3%, or 434,057%. Consistency was the key to Berkshire's outperformance for over those 44 years the S&P 500 suffered 11 down years, six of which were double-digit declines. Berkshire, however, had only two negative years, neither of which were double-digits. Such risk-adjusted investing has always characterized Warren Buffet, for he maintains it isn't his best ideas that gave him his tremendous track record. It was having a smaller number of bad ideas that resulted in a permanent loss of capital. "We haven't taken two steps forward and one step back. We've taken two steps forward and a fraction of a step back. Avoiding the catastrophes is really important."

As usual, Warren Buffet peppers this year's letter with witticisms that offer useful gleanings to investors. We particularly liked the section titled "What We Don't Do." The first bullet point reads:

"Charlie and I avoid businesses whose futures we can't evaluate, no matter how exciting their products may be. In the past, it required no brilliance for people to foresee the fabulous growth that awaited such industries as autos (in 1910), aircraft (in 1930) and television sets (in 1950). But the future then also included competitive dynamics that would decimate almost all of the companies entering those industries. Even the survivors tended to come away bleeding."

We revisit Warren Buffet, and Ken Fisher's, comments this morning because we think 2010 is a transitional year where being "conservative not conventional" is the preferred investment strategy. Accordingly, we like high quality "growth" over "value" and are avoiding companies with highly leveraged balance sheets. We are also looking for companies whose earnings forecasts are being revised upwards, as well as companies with dividend yields. We prefer large capitalization stocks because the drag on relative performance from narrowing credit spreads is waning. Moreover, the current economic, and credit, environments are worse for small/mid-caps; and, large caps tend to outperform when the economic momentum peaks like it appears to be doing. Further, large capitalization companies' P/E multiples are 20% below those of the small/mid-cap complexes. That said, we are always interested in special situations, no matter what their capitalization flavor.

If indeed this turns out to be a transitional year, we think investors should employ a more dynamic strategy in part of their portfolios. This does not mean we favor the "rapid fire" strategy of trying to day-trade, or even trade on a week-to-week basis. Rather, we favor waiting until the risk/reward ratio is tipped so far in our favor that if we are wrong, we will be wrong quickly with a [Please read domestic and foreign disclosure/risk information beginning on page 4 and Analyst Certification on page 4.](#)

de minimis loss of capital. For example, we entered 2010 in a pretty cautious mode, worried that the first few weeks of the new year have historically been tricky. Subsequently, we determined the equity markets had fallen into a “selling stampede.” Knowing that such stampedes tend to last 17 to 25 sessions we remained cautious, but continue to add stocks to our “watch list.” Following the climatic downside deluge of February 4th and 5th, we opined the stampede was abating and recommended tranching into (read: buying partial positions) some of the stocks on our various lists. We still feel that way.

That positive view was reinforced last week when the 10-day exponential moving average (EMA) crossed above the 30-day EMA. Additionally, the 50-DMA is turning up and on February 5th the number of S&P 500 stocks above their respective 50-DMAs had shrunk from 92% to ~19%. While that oversold reading has been somewhat corrected by the ensuing rally, roughly 50% of the S&P 500 stocks still remain below their 50-DMAs. Then there was this insight from Minyanville professor Tony Dwyer:

“One indicator that has proven to be an excellent short and intermediate-term buy signal for the S&P 500 is when the percentage of NYSE issues trading above their 10-DMA drops below 10%. The most recent signal was (on) 2/18/10, which represents only the 8th unique instance (rapid multiple signals following the first signal were ignored) in the past 30 years. The average one month gain following the first signal was 5.4%, with a maximum gain of 11.2% and the worst case (and only) loss of 1.31% in 1991.”

Hence, we continue to believe the “selling stampede” is over. To us the question then becomes, will we extend the current rally off February’s “hammer lows,” or will the pattern resemble that of the 1978 and 1979 “October Ouches” whereby the DJIA lost between 10 – 12% in a few short weeks and then bided for a month, or two, before giving investors a decent rally. Worth noting is that the DJIA never went decidedly below those “hammer lows,” as can be seen in the attendant chart.

In past missives we have suggested many names for your consideration like CVS (CVS), Cenovus Energy (CVE), Home Depot (HD), Alpha Natural Resources (ANR), and numerous others that can be retrieved from previous reports. And as an aside, China reported last week that it has spent record sums on the importation of coal and liquefied natural gas, which is clearly positive for coal names like Walters Energy (WLT). This morning we give you yet another special situation, namely Goodrich Petroleum (GDP) using its 7.5%-yielding convertible preferred (GDPAN/\$35.60). As always, terms and details should be vetted before purchase.

The call for this week: Recently, various economic reports have softened. Why this should come as a surprise is a mystery to us given the stock market’s decline, the employment situation, a political environment that is disgusting on both sides, and a winter that is now legend. However, “Life isn’t about waiting for the storms to pass. It’s about learning to dance in the rain!” Clearly, we are currently “dancing,” thinking the “selling stampede” is over with the only question being, “do we extend the rally off of the February 4th and 5th ‘hammer lows,’ or do we base for awhile as in the aforementioned 1978/1979 examples?” What does concern us was best written by East Shore Partner’s creditable Joan McCullough. To wit:

“George Will said it best when he talked about the equality of opportunity vs. the equality of outcomes. Where the former requires self-determination, the latter requires dependence on the government. Make no mistake about it, we are now all about the ‘equality of outcomes,’ where it only matters, for example, that all adults by age 21, will have 4-year college degrees regardless of ability to write a coherent sentence or multiply 3 x 2.”



Source: Thomson Reuters.

Public companies mentioned in this document.

Company Name	Ticker	Exchange	Recent Closing Price	RJ Rating (if Applicable)	RJ Rating Organization
Alpha Natural Resources	ANR	NYSE	46.01	1	RJ & Associates
Berkshire Hathaway Inc.	BRK.A	NYSE	119800.00		
Cenovus Energy Inc.	CVE	NYSE	24.50	1	RJ Limited
CVS Caremark Corporation	CVS	NYSE	33.75	1	RJ & Associates
Goodrich Petroleum Corp.	GDP	NYSE	19.27	2	RJ & Associates
The Home Depot Inc.	HD	NYSE	31.20	1	RJ & Associates
Walter Energy Inc.	WLT	NYSE	78.57	2	RJ & Associates

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