MV Capital Management E-Update

The Prudent Man and Mr. Market

August 31, 2007

"Those with responsibility to invest money for others should act with prudence, discretion, intelligence, and regard for the safety of capital as well as income."
Judge Samuel Putnam, *Harvard College versus Amory,* Massachusetts (1830)

That time-tested quote is one of the foundations on which the investment profession in our country is built. It was originally known as the Prudent Man Rule, has been adapted over the years to accommodate advancements in the science of investment and portfolio management, but it is still the gold standard to which any practicing investment advisor, in his or her capacity as a fiduciary for the wealth of somebody else, is held. It is hard to imagine those words – prudence, discretion, intelligence, regard for safety – as ever going out of fashion.

As the tumultuous month of August closes the curtain on this Summer of Volatility we thought it would be a good idea to dust off this quote and shine the light on something that Judge Putnam probably never could have imagined back in 1830 – the nightly parade of media entertainment shows that purport to offer "financial advice". Do you ever notice that the decibel level of these shows seems to increase as volatility in the markets rises? Right at the time when investors are most in need of prudent, intelligent advice they are treated to the theatrical antics of shows like "Mad Money" on CNBC and other feverish entreaties to jump in, get out, scoop up bargains, dump everything, shake it all about. Unfortunately, human emotions being what they are, more than a few people actually believe that these shows exist to educate, inform and advise investors rather than simply to create ratings and profits for their parent companies.

We recommend living by a simple maxim: the louder and more pervasive the TV coverage of the stock market, the stronger the case to turn the TV off and do something else. Read a book (that has nothing to do with getting rich, quick). Write the words "prudence, discretion and intelligence" on a piece of paper 100 times if you have to. Look at the longer-term charts – the ones that show one, two and five year performance, not just the last week of trading. The S&P 500 is still up by more than 13% on a twelve trailing months basis as we write this. Just don't buy, sell or do whatever else some wild-eyed TV personage with purple veins throbbing on his forehead is entreating you to do.

Case in point: on August 20 an article in the reputable investment publication Barron's reported that over the past two years the stock picks of Jim Cramer, the "Mad Money" guy on CNBC, had gone up by 12% as compared to a 22% gain in the Dow Jones Industrial Average and 16% gain in the S&P 500. And that's *without* taking into account the considerable transaction costs associated with continually buying and selling in an active market-timing strategy. Surprising? It shouldn't be to any regular reader of these e-updates, where as recently as April of this year we decried the seductive manias of market-timing in favor of long-term disciplined strategy.

Disciplined strategies don't sell ratings, however, and selling is what the media conglomerates are all about. One of the most disciplined investment strategists of the 20th century, Benjamin Graham, coined the phrase "Mr. Market" to describe the irrationality of short-term volatility. Mr. Market is an emotional train wreck, a highly volatile type given to manic bursts of giddy euphoria and suicidal depression. Needless to say, the media folks love Mr. Market! Mr. Market panics when subprime loans are wreaking havoc and sells all his bank stocks regardless of how

exposed any of them are to low-quality debt. He buys up Internet stocks when they have $50 billion market caps and negative cash flows. He uses the phrase "this time it's different!" a lot. And of course it never is different.

Now, anyone out there who fashions him or herself as a savvy market-timer or stock-picker is going to say, hey, that's not me! I'm on the other side of those trades; I'm the Anti Mr. Market! Surely no self-respecting stock maven on CNBC is going to admit to being anything less than utterly brilliant in maneuvering through the perilous shoals of short-term volatility. The thing is, though, that in playing the short-term game you are still playing by Mr. Market's rules. Yes – every now and then you'll find yourself on the right side of a trade and be tempted to think of yourself as a genius. But market-timing is generally a loser's game.

The fact is that disciplined investing is a boring, unsexy process. Prudence and discretion aren't particularly exciting traits. Strategic asset allocation is a dry exercise with lots of mathematics and sleep-inducing phrases like efficient frontier and positive kurtosis. Be that as it may, strategic asset allocation is also what drives over 90% of portfolio performance attribution, according to most established investment studies. Stock picking, market timing and other techniques account for much less of the variance in results over time. Put another way – most of what drives long-term performance has to do with a disciplined allocation strategy. If that's boring then we are proud to be boring. Otherwise called: prudence, discretion, intelligence and regard for safety. There are worse things to be called than that.

With warm regards,

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