



How To Control Investment Risk

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Most investors I meet claim to be 'risk – averse'. After some conversation I often find they can't be very specific as to what that means. A simple 'I don't want to lose money' really doesn't address the issue sufficiently in our complex world. Some thoughts.

There are two main types of investment risk: permanent loss of capital, and lower prices. The first is easy to understand. You make an investment in something, you find out later the money is all or partially gone, no hope of recovery. This tends to happen more often when investing in 'start – up' ventures, whether in your own business, with an acquaintance or family member, or in Securities through an Initial Public Offering (IPO). Infrequently a more mature venture will take on too much debt, and the equity becomes worthless. As rare as permanent losses are, smart investors work hard to avoid them.

The second type of risk, lower prices, is very different. Investors in Securities (stocks, bonds, mutual funds, ETFs, etc.) are very likely to experience lower prices. Example: since 2000 the U.S. Stock Market has twice tumbled more than 50% !

But it's enigmatic because, to some, this type of 'volatility' represents opportunity, not risk.

As Warren Buffett counsels, 'markets' offer you a chance to buy or sell, but you are free to choose when to do either. So if the price of a stock you own tumbles, you can ignore it and simply continue to hold. Usually if it's of good quality, it will be worth more later. More opportunistically, you might decide the price is below some 'fair value', and buy more. In his typical easy style Warren says that when he goes to buy bread he hopes it's on sale. So too, as you add to your long – term holdings, you're best served if you pay low prices. Done successfully, however, this requires the experience and ability to 'know' that the market is wrong, and the courage to act on your conviction.

This is the essence of Value Investing. The discipline is to determine the true 'value' of a security. In the purest sense value investors don't try to predict the success of some new division, or what new products might sell well in the future. Instead they want to know 'today's' value. Then, if the market tumbles, they can buy below

this 'value', confident the future for their investment is bright.

Buffett often repeats, 'Volatility is the friend of the long-term investor'. This points out another enigma. Younger investors can ride out the cycles. Older investors, however, are usually more nervous, rightfully wondering if they are, in fact, long-term. There's no easy answer as part of it is psychological. Some investors lose a lot of sleep during volatile periods. Some get so stressed that they liquidate. This, of course, is usually a poor choice since they won't be owners when the inevitable rebound occurs.

Conclusion. Like most issues in investing, risk isn't black and white. My experience, however, is that being educated, and setting up a well-thought out strategy can be of great help to investors, both young and old. It can allow them to think through the different risks, and intelligently establish the risk parameters that fulfill their needs, and their psyches. Risk and opportunity are both alive and well in 2014. Please don't hesitate to call on me or any of my colleagues if we can help you be better, more risk-averse investors.

The Short and Long of It

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Warren Buffett famously said that the ideal holding period for a stock is forever. The recently published Michael Lewis expose' of high frequency trading (HFT) – Flash Boys – suggests that HFT firms vie to hold securities for such tiny fractions of a second that it makes a hummingbird's wings seem slow. How can such rapid fire trading even be considered investing?

It's not. Lewis is a fine writer whose earlier works about the seamier side of financial markets – Liars Poker, The Big Short & Boomerang to name a few – have all been well crafted & eye-opening reads. Flash Boys has created an uproar on Wall St. by exposing how speedy technology allows the HFT specialists to “front run” large institutional investors and skim pennies per share from a large portion of daily trading volume on numerous exchanges. These transactions, of course, have nothing whatsoever to do with even a cursory evaluation of the real companies whose shares are being bought or sold. Rather, they occur simply because of the large volume of common stock that trades daily in the U.S. markets. This trading strategy is only possible because fast computers & data networks have completely removed the human element from the process.

HFT is perhaps the final step in the trend toward ever shorter holding periods of publicly traded securities. It is the complete antithesis of long term Value Investing epitomized by Buffett's Berkshire Hathaway and the other great investors we follow. While those

skimmed pennies probably have little long term effect on our clients' portfolios, the mere existence of HFT certainly adds to the impression of many that the stock market is, as Michael Lewis claimed on 60 Minutes, a “rigged game”.

Such short term-ism is and has been an increasing issue over my 30+ year career in financial services and investment management. It's almost difficult to remember that quaint era when we had to open the Wall St. Journal each morning to see how our investments did the day before. The Internet & the 24 hr. news cycle changed all that, and now mobile computing compounds the info. overload that applies to every aspect of daily life. But being able to do something fast doesn't mean that you should.

Long term planning and investing based on thoughtful analysis of trends that affect economies, industries and companies is more difficult when we're constantly immersed in a cacophony of conflicting data, opinion and outright B.S. Just because someone says they're an expert doesn't make it so. If we at VFA are good at anything, it's filtering true wisdom from all of the noise – and believe me, it's mostly noise. Given that short term-ism also produces more volatility in asset prices, it also means we need a larger margin of safety in security selection than in the past. Does this sometimes test our patience? Sure. But that is far better than following the crowd over the next cliff. Being a contrarian is, by definition, hard – but the rewards are worth it.

Workshop

Six Reasons You Don't Want a Living Trust & Smart Ideas for Leaving Your Estate

Revocable trusts continue to be over-sold and over-used. For most Americans the costs and aggravations are high, the advantages small to non-existent. Ford Wheatley, Esq. will discuss what trusts 'don't' do and why you might not need one. With Bill Connors they'll explain other 'smart' ways to handle your estate planning that often work better, with much lower costs and hassles.

Wednesday May 21, 10:00 am until noon

Our Workshops are Free, but Reservations are Required !

Seating is Limited. Feel free to invite family and friends.

Call (303) 770-3030

A Little Shine This Quarter

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The 1st quarter of 2014 was profitable for those holding Gold and Gold Miners. The metal was up almost 7 % with many miners up double that (btw. S&P 500 up just + 1.8%). This helps Gold make up for a poor 2013. Investors need to remember that short-term prices are often erratic and illogical, but in the long-term cream rises to the top. In the last 10 years, for example, gold handily beat all broad stock and bond indices. Interest rates remain artificially low and the Fed's stated policy is to maintain this for several years. This encourages Investors to seek higher returns in stocks, real estate, etc. History, however, suggests that artificially low interest rates create bubbles, and inflation. As of today, few investors are worried: Stocks did great last year, investors seem confident 2014 will be similar. A warning: history also suggests that 'the crowd' is usually wrong about this sort of thing, time will tell.

In our Annual Roundtable Meeting held in January, we recorded some segments we felt were important to explain our outlook on different areas of investing. These videos can be seen on our website at www.valuefin.com. One six minute piece addresses Gold, we invite you to view it. We are not Gold bugs. However, observing the money printing by the world's central banks, we're holding some to protect portfolios against inflation. The history of inflation suggests it is benign in the early stages, which encour-

ages more stimulus, because there are few negative consequences. But as Jimmy Carter learned in the 1970's, getting the genie back in the bottle can be quite difficult, and unkind to investors who were complacent.

Gold costs about \$ 1,200 to produce; this creates sort of a 'floor' for the price. Gold opened 2014 at \$1,205 an ounce, and at the current \$ 1,300 per ounce we believe demand will increase and prices will eventually follow. In our Gold video, Scott Taylor mentions how the short-term pricing of gold is very different than a decade ago. Gold can now be traded as a stock (ETFs), so investors should expect it to trade like one. Gold prices will likely continue to be volatile. Investors often flock there when equities or fixed incomes are performing badly, and stockpile gold when inflation heats up.

Though the short-term price of Gold will likely be erratic, the long-term reasons for holding the metal haven't changed. Experimental money printing to stimulate has not worked as the Feds had hoped, yet they continue to print massive amounts. Inflation is a natural phase of the economic cycle, and can likely only be contained for so long before it erupts. If you are concerned about this, owning some Gold may offer you protection, similar to insurance, particularly over the long-term.

What Every Investor Needs to Know Right Now

William Mason CFA

The Federal government activities are the primary reason that there is an economic recovery (the worst recovery since WWII) and the government has been instrumental in the rise of stock prices since 2009. The government, through borrowing and spending, has become the economic manipulator. Seven years ago, on April 3, 2007, Federal government debt was \$8.9 trillion. It took 231 years to get there. Today that debt is at \$17.6 trillion. They doubled it in 7 years. They borrowed it and they spent it. Let's put that number in perspective. The last crisis was primarily a mortgage debt driven problem. According to the Federal Reserve, at the end of 2013, there was \$9.8 trillion of mortgage debt on one – to – four family residences. They could have basically paid off every home mortgage in the country. That is how large \$9 trillion is. It is a staggering number.

The government, through the Federal Reserve's ability to print money, has become the market manipulator. The Federal Reserve has printed almost \$3.5 trillion in the last 7 years. They use the money to buy bonds. As Dallas Fed governor Richard Fisher stated on April 4: "By buying copious quantities of longer-term U.S. Treasury bonds and mortgage-backed securities (MBS), our balance sheet has grown from slightly under \$900 billion prior to the crisis to \$4.3 trillion at present."

By buying bonds they step on longer-term interest rates driving them to absurdly low levels. Let's continue with comments from Fisher: "We now own just shy of 24 percent of the stock of Treasury coupon securities. Having concentrated our purchases of Treasuries further out on the yield curve, and done so in size, we have driven nominal interest rates across the credit spectrum

to lows not seen in over a half century."

Fisher is well aware of the influence (manipulation) of Fed money printing (which they call Quantitative Easing or QE): "Quantitative easing has made life easy not only for corporate treasurers and homeowners and consumers burdened by debt, but also for money market operators. It has run up the price of stocks and bonds mostly in straight-line fashion, and it has taken volatility out of the marketplace, allowing market operators and their clients to profit with little effort."

They are now cutting back on money printing. They are down to \$55 billion per month from \$85 billion per month throughout 2013. The intent is to be printing no more by October. What do you think will happen? As stated by Deutsche Bank on April 11: "We can't help thinking that as it becomes ever clearer that the Fed is pretty much fixed in its determination to stop QE late this year, the oxygen that has fuelled the 5 year bull market is slowly draining out of the market."

The great value investor Seth Klarman wrote the following in the Baupost Group annual report this year: "Someday, rising stock and bond markets will no longer be government policy. Someday, QE will end and money won't be free. Someday, corporate failure will be permitted. Someday, the economy will turn down again, and someday, somewhere, somehow, investors will lose money and once again come to favor capital preservation over speculation. Someday, interest rates will be higher, bond prices lower, and the prospective return from owning fixed-income instruments will again be roughly commensurate with the risk."

I think it is a time to be cautious. I favor the safety of FPA New Income. I also favor oil and gold related investments.

As Charlie Munger, Vice-Chairman of Berkshire Hathaway, said to value investor Howard Marks regarding investing: "It's not supposed to be easy. Anyone who finds it easy is stupid."

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