

THE EDUCATED INVESTOR

Winter 2004

Cypress Asset Management

How Does Your Market Grow?

Although it took most of us by surprise, it's no secret now — 2003 was the best year for equity investors in the last quarter century. We haven't experienced such high annual returns since 1975–1976 (when global markets were recovering from the bear market of 1973–1974). The equity asset class with the least annual growth still exceeded 25 percent returns, and the highest-growth equity asset class exceeded 70 percent returns. Wow.

Who knew? In the beginning of 2003, the average *optimistic* financial economists were forecasting long-term returns in the

neighborhood of 6 percent, well below the market's long-term historic annualized return of about 10 percent. Pessimistic economic forecasts were even worse, as some predicted a severe short-term reversion to historic mean valuations.

Gloomy predictions seemed likely to be fulfilled as 2003 headlines flashed before us a world filled with war, disease and corruption. Yet throughout the second half of the year, the market behaved like a horse with blinders on, trotting briskly onward (and upward) in blissful ignorance of the surrounding mayhem. There was no reversion to the mean. The economy overcame many obstacles, and corporate profits also grew rapidly, fueled by the strong economy and a tremendous increase in productivity.

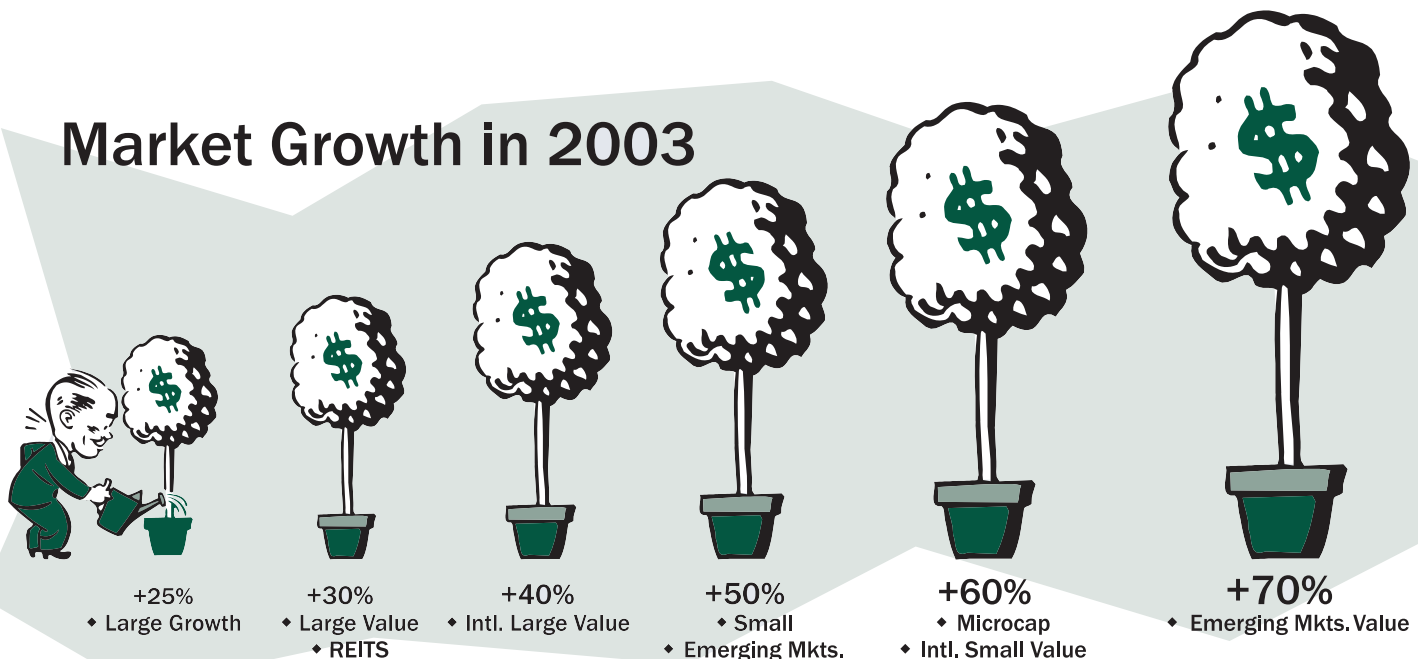
The upset returns of 2003 provided us with many reminders of the principles of prudent investing.

Stay the Course

In the face of record-breaking years like 2003 and heart-breaking years like those immediately preceding, we continue to recommend that you maintain a disciplined “buy, hold and rebalance” approach to your portfolio. Just as in the similar bear-followed-by-bull period of 1973–1976, if you adhered to a disciplined approach you were prepared to reap satisfying benefits from 2003's gains. Had you instead fled the market after experiencing severe losses, you ended up doubly punished by missing out on the subsequent surprise recovery.

Continued on page 2

Market Growth in 2003



How Does Your Market Grow? (cont.)



In other words, there seems to be little theoretical or practical evidence that you can predict which way the market is going to veer next. But there is a solid body of academic research and real-life examples illustrating how markets work and why remaining fully invested throughout seems to be the best way to maximize long-term returns and minimize the expense of trying to do so.

Diversification Is Key

Diversification across a wide range of asset classes is like insurance. You gain protection against being heavily invested in one or a few big losers that could ruin you. In exchange, you forego the chance to be heavily invested in one or a few winners that might help you quickly strike it rich. Like with

insurance, diversification is always working, whatever the outcome. For example, international equities outperformed US equities in the 1970s–1980s and underperformed in the 1990s. In 2003 they outperformed again, quite dramatically. Throughout, there was little or no ability to predict the events as they unfolded. Because you don't know where the "roulette ball" of outperformance is going to fall next, your best bet is to stake your claims all around the wheel.

Plan For Good Times and Bad

Whether you are working with an investment advisor or going it alone, careful, expert planning is your greatest protection against yourself:

- ▲ Formalize your plans by writing an investment policy that reflects your unique ability, willingness and need to take risk; outlines the objectives you seek to

achieve; and describes how you seek to achieve them.

- ▲ Include guidelines in your plan for when you will rebalance your portfolio to its original allocations (after market fluctuations have caused it to shift). This helps you buy and sell according to a plan rather than haphazardly.
- ▲ Build your globally diversified portfolio of various equity asset classes and fixed income holdings based upon your written plan.
- ▲ "Stress test" your planned portfolio before it is implemented. Consider how it would have performed in very difficult markets such as 1973–1974. If you think you might abandon your plan under such stress, then you should plan a less risky portfolio.

Forewarned about your reaction to difficult markets is forearmed against panic reactions that might cause you to "sell low" and miss

Continued on page 3

Same Market, Different Investors

During **bull** markets
(when market prices rise higher than usual) ...

1. Your portfolio performs well, so you achieve your objectives sooner than expected.
2. If you *participated* in the bull market you might consider *lowering* your need to accept future investment risk (by reallocating to less-risky equity asset classes or more fixed income).
3. Because market prices are higher than usual, reversion to the mean can be expected (although nobody can predict precisely when), resulting in expected lower future returns.
4. If you are *just beginning to invest* you might consider *increasing* your need to accept future investment risk (by reallocating to riskier equity asset classes or less fixed income).

During **bear** markets
(when market prices drop lower than usual) ...

1. Your portfolio performs poorly, so you are further than expected from your objectives
2. If you *participated* in the bear market you might consider *increasing* your need to accept future investment risk — to help your portfolio "catch up" to your goals (by reallocating to riskier equity asset classes or less fixed income).
3. Because market prices are lower than usual, reversion to the mean can be expected, resulting in expected higher future returns.
4. If you are *just beginning to invest* you might consider *decreasing* your need to accept future investment risk (by reallocating to less-risky equity asset classes or more fixed income).

How Does Your Market Grow? (cont.)

out on an ensuing recovery. Likewise, it is equally important to remain steadfastly diversified when the market roars forward. Which brings us to our next point ...

Learn From the Past — Invest in the Future

It is important to avoid the mistake of “rency” which results in chasing yesterday’s returns when we can only invest in tomorrow’s gains and losses.

As we begin 2004, many investors are likely to be tempted to bulk up on last year’s winners such as US microcap and emerging markets. In reality, these winning asset classes’ future expected returns are actually *diminished* by their past gains. Instead of trying to chase winners and avoid losers, we advise you to use your carefully designed investment policy as your decision-making guide.

The impact of market movements is relatively complex and affects different investors differently. Consider the illustration on page 2, “Same Market, Different Investors,” for an explanation of why differing responses to the same market movement may be appropriate, depending upon factors unique to you and your portfolio.

Choose Your Friends Carefully

Most of the lessons taught in 2003 came wrapped in the sugar coating of spectacular returns. One more bitter pill came in the form of a whirlwind of allegations that even some of the best-known mutual fund firms might have been allowing illegal late trading and “market timing” arrangements to benefit a few at the expense of many.

Absolute protection against such upheavals can never be guaranteed. However, we think recent events illustrate the importance of aggressively seeking certain characteristics in one’s investment allies, including but not limited to the following:

1. Select fee-only, non-commissioned investment advisors. Fee-only advisors only achieve their goals if your portfolio grows. A commissioned advisor makes money whenever you buy or sell, regardless of whether the trade is in your best interest.
2. Seek mutual fund companies who have a stated and *demonstrated* commitment to minimizing expenses, addressing tax issues and providing you with on-going education on how to pursue a prudent, long-term investment path.

What’s in Store for 2004?

Nagging questions remain. Why was the news so bad and yet the performance so good in 2003? Why were returns so different from those of the preceding years? What can we expect in 2004? We leave such analysis to the popular media pundits who are feverishly if retroactively proposing answers.

Our answer: Like the ocean, the market is what it is. You can’t control or predict it. The best you can do is diversify across it for best access to its gains, keep the rudder steady when you pitch downward and hang on tight when the waves crest. Last but not least, ignore the short-term movements and keep your eye firmly on your investment horizon. Over time, we think it offers the best view.

It’s a Small World, After All

While general market returns were a sight for sore eyes in 2003, the fact that all the international asset classes outperformed their US counterparts underscores why we include the “global” in our recommendations for global diversification.

Of course we do not expect international to perpetually outperform domestic, any more than we expect the reverse. But what comes as a surprise to many is that by adding international assets to a portfolio you can actually expect to achieve higher overall returns at reduced overall risk.

To illustrate this point, Standard & Poor’s Chief Investment Strategist David Blitzer constructed a portfolio that was 60 percent US and 40 percent international holdings and analyzed the period from January 1970 to February 2000.¹ The study concluded that no single country — including the US — produced a higher return than did the overall portfolio, and the portfolio’s standard deviation (measure of volatility) was below that of any single country.

Another reason some investors cite for eschewing international equities is to avoid “currency risk,” or the risk that foreign holdings will lose value if their country’s currency falls in comparison to the US dollar. In reality, currency risk is a two-way street. This was illustrated in 2003 as the US dollar fell dramatically against the Euro, positively impacting international equity returns. In fact, because currency risk reduces the correlation (similarity) between US and foreign equities, it plays an important role in building a portfolio that is more diversified and less risky than any of its individual holdings.

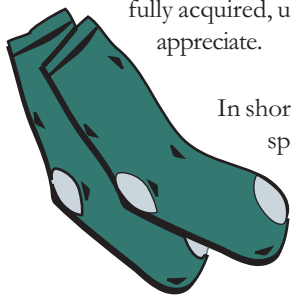
¹ David Blitzer, *Outpacing the Pros*.

The Difference Between Stocks and Socks

Along with the new year arrives the advent of articles, advertisements and announcements proclaiming 2004's "best buys" for the latest automobiles, appliances and entertainment centers.

Once you cull through the hype, the information can be very helpful. Especially for major purchases, you may spend considerable time checking out the ads, surfing the Web, reading *Consumer Reports*, talking to friends, taking test drives, or going shopping to physically see and touch your heart's desire.

All of this due diligence is generally important when buying tangible goods. It takes time, but you are rewarded because you will be the one actually using the item. Even though others will make similar purchases, theirs will neither help nor hinder your enjoyment of your own purchase. Future improvements or price reductions may make you wish that you had waited just a little bit longer, but you still have a thoughtfully acquired, useful item to appreciate.



In short, researching specific hard assets before buying them can be prudent, since their value will

be determined primarily by how thoroughly *you* enjoy using them. In contrast, we caution investors to avoid spending similar time and effort on researching individual equities to hold in their portfolios. We advise you to ignore financial magazine articles on the latest hot stock and mutual fund tips; to tune out brokerage research reports, media gurus or whatever latest investment trend your friends are bragging about; to forget about the current popularity of Amazon versus eBay, or the auto versus the electronics industry.

Why the difference? First, the reason for making the purchase is (or should be) quite a bit different. When you buy a stock or stock mutual fund, you only receive a certificate or book entry on your financial statement. Nothing that directly keeps you warm at night. You might earn dividends, but you fulfill the investment's primary purpose when you sell the asset and hope to receive more than you paid for it. This differs markedly from the purchase of tangible assets such as socks, that you essentially plan to enjoy and use up until they are of little or no value to anyone.

Further, the future value of an investment is not based on how much mileage or loads of laundry were achieved, nor on how much your holding is worth to *you*. Even if you successfully conduct extensive research to predict future economic trends and



company profits, the stock is still valued on what the overall "market" believes the investment is worth at the time of the sale. Ultimately, the price at which a stock is sold will depend on how much *another investor* is willing to pay for it.

In other words, a product's value is based on your own personal experience, so evaluating specific qualities of that unique item is important. An investment's value depends not only on future unpredictable events, but also on how others will interpret this information. Once purchased, the ultimate value of your investment is beyond your control. This is one of the key reasons we urge you to forego the time and effort it takes to painstakingly research and invest in individual stock holdings. Your time is far better spent reading authors such as Larry Swedroe, Charles Ellis, John Bogle, William Bernstein and others who describe in layman's terms how the markets work — and how you can take steps that help them work in your favor.

You can best expect to capture market returns by constructing (and periodically rebalancing) a diversified, global portfolio comprised of funds that capture entire asset classes. You can then devote the rest of your research time to selecting your favorite vacation destinations, and to deciding what color socks you will pack.

Our Basic Tenets

Our objective is to design portfolios using passive asset class funds that maximize investors' returns within their tolerance for risk. Here is what sets us apart:

- ▲ Fee-only investment management
- ▲ A disciplined investment strategy
- ▲ Access to institutional no-load passive asset class funds
- ▲ Fixed income expertise

- ▲ An academic Nobel Prize-winning investment approach
- ▲ Continued access to academic research
- ▲ A tax-efficient focus, with valuable tax and estate-planning ideas
- ▲ Risk tolerance assessment
- ▲ Periodic portfolio rebalancing
- ▲ Regular communications and state-of-the-art reporting
- ▲ **MOST IMPORTANT ...**
A TRUSTED ADVISOR RELATIONSHIP



CYPRESS ASSET MANAGEMENT

1 N. Seventh St. Pekin, IL 61554

P 309-347-2440

F 309-347-7705

web www.cypram.com