

## “Buying High & Selling Low”: The Portfolio Killer

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**A**ccording to market data compiled by the research company Strategic Insight, the year 2009<sup>1</sup> saw net inflows to bond funds (including mutual funds and ETFs) of about \$396 billion dollars. Meanwhile, net inflows to U.S. stock funds were a paltry \$6 billion. This statistic makes me a ‘little’ upset, and here’s why.

From its peak in October 2007 to its low of March 2009, the S&P 500 declined about 45%<sup>2</sup>. You would think that investors, eager to ‘buy low and sell high,’ would pour into the stock market. For example, Warren Buffett put money into the stock market. He bought shares in Goldman Sachs and General Electric. Smart move, as it turns out. His initial \$3 billion investment in Goldman Sachs is now worth over \$5 billion, based on dividends and market prices. However, according to the statistics, almost every other investor was selling low instead of buying low. \$396 billion of bond purchases and \$6 billion of stock purchases tells a pretty clear story.

So why is the market up 60% from the bottom of 2009? Because the smart money, the institutional money, is buying stocks. Where are these institutions getting the cash to do this? In part, from the \$396 billion dollars that the smaller investors have put into bond funds. We are loaning out money at 4%, and the institutions are using that collateral to buy stocks and make a killing. After we smaller investors have gotten over our fear of the stock market, they will be happy to sell some of that stock back to us. So we sell at a 40% loss in 2008 and 2009. And then buy at a 60% markup in 2010 and 2011. Buy high and sell low.

Sloppy investing like this has actually worked over the last few decades because all asset prices were going up. The average American saw historic bull markets in stocks, bonds, commodities and real estate. There was no such thing as buy high, sell low. We only had to buy high and sell higher.

Today, with many investors having lost half or a third of their life savings, the herd mentality is no longer a group of charging bulls, but rather galloping lemmings. If your portfolio is only up 20 to 40% since the bottom, you should be concerned, because Wall Street fat cats have captured the other 20-40% of your money.

#### **SAFETY**

The problem is that many people think equities are always riskier than bonds. This has been largely true in the past, but as we like to say in this industry, ‘past returns are not always indicative of future results.’ Today’s standard A-rated ‘government’ bond fund holds a lot of mortgage-backed debt. It is allowed into the ‘government’ sector because Fannie Mae, the primary issuer of mortgage-backed debt, is a quasi-governmental entity. If you are invested in a target-date retirement fund, such as those commonly available from Vanguard, Fidelity or Schwab, with a retirement date of 2010 or 2015, you have plenty of money invested in Fannie Mae bonds, and other pure real estate investments. You are earning a rate of return of approximately 4% on these investments.

Why on earth are real estate and mortgage-backed bonds considered ‘safe’ investments? Today, according to research by the Mortgage Bankers Association, 4.58% of all U.S. mortgages are in foreclosure, and another 9.47% are delinquent (meaning at least one payment has been missed)<sup>3</sup>. If I recommended you put \$100,000

into an investment that was guaranteed to lose 4.58%, and perhaps another 9.47% (a total of 14% or \$14,000), what rate of interest would you want to off-set your risk? If you do some quick math as follows, you would want at least 14% (or \$14,000) in gains to make-up for the losses. Since inflation is almost 3%<sup>4</sup>, you would want another 3% (or \$3,000) to make-up for inflation. In short, you need a 17% gross rate of return just to break even in a year. If I told you the investment only offered a 4% rate of return (again, that's the current yield on most government bond funds), would you still put \$100,000 into it? I would venture to bet you would not.

Fortunately, Fannie Mae bonds are quasi-guaranteed by the federal government, so it is not likely that the defaults will directly affect bondholders. However, the Federal Reserve has purchased about \$1.25 trillion<sup>5</sup> of these bonds in the last year, in an attempt to force down interest rates and keep the real estate market from getting worse than it already is. Now the government wants to start selling these bonds. Folks who currently own a lot of these Fannie Mae bonds face a real risk of capital loss as this occurs. The only reason it is not a downright crummy investment is because of the government guarantees, which means bondholders are dependent on 1) government subsidies and 2) government actions in the open market. I do not like those odds. And I do not consider real estate and mortgage-backed securities to be 'safe' or even 'safer' investments

## **RISK**

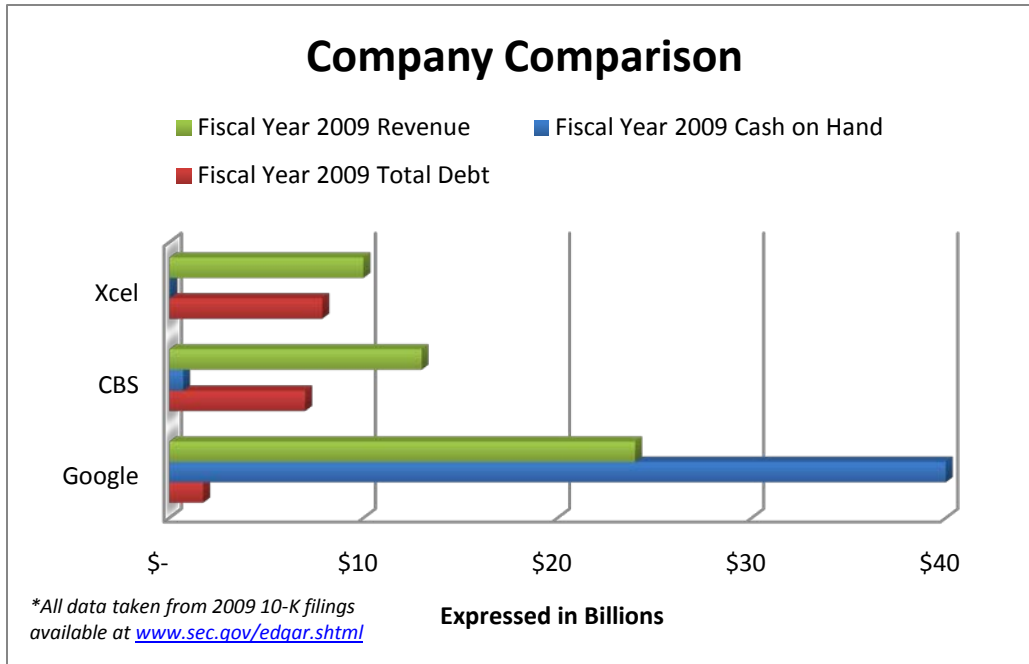
Now let's look at a 'risky' investment. Let's look at one of the riskiest, an internet company like Google. In the past, 'internet companies' have equated to risky investments.

For FY 2009, Google had revenues of almost \$24 billion. Almost all of that revenue came from sales of advertising. For comparison, other companies that generate most of their revenue from advertising are radio and television companies. CBS had revenues of about \$13 billion in FY 2009, making one of the largest television stations in the country barely half the size of Google. Industry trends have seen advertising money spent on print, radio and television declining, while advertising on the internet continues to grow. Corroborating that trend, CBS has less than \$1 billion of cash on hand and nearly \$7 billion in debt. Google has \$40 billion in cash on hand, and \$1.75 billion in debt.

Perhaps the comparison to CBS is not fair, since Google does not provide content. Technically they are only a conduit to the content, a utility that exists so we can use the internet. Utilities are strong investments because of consumer commitment. When my wife and I bought a home, we had already committed to paying for gas and electricity, every month, for the rest of our lives. Similarly, when we consumers purchase a computer, we are generally making a commitment to use its software and internet abilities.

To make a utility comparison, Xcel Energy is the company my wife and I use to provide electricity to our house. It had revenues in FY 2009 of just under \$10 billion. We use Xcel to run our light bulbs, dishwasher, microwave and other items that provide a lot of money to Xcel. As a reminder, Google's revenues in 2009 were \$24 billion. We use Google for shopping, research, reference, getting directions and a host of other items that provide a lot of money to that company.

Bill Gross, an investor who is to the bond market what Warren Buffett is to the stock market, suggests in a recent newsletter that utility stocks are a better buy than bonds right now. I wonder if he meant utilities like Xcel, or utilities like Google and Microsoft? By the way, Xcel has about \$0.04 billion in cash on hand, and \$7.88 billion in debt.



#### DISCLOSURE

For full disclosure, few if any of our clients hold direct stock in any of the aforementioned companies. However, almost all of our clients hold some Google stock through various mutual funds, and to a much smaller degree Xcel and CBS.

#### CONCLUSION

In conclusion, please do not buy bad

investments. It pains me to see the little guy get run over by the fat cats. If you only want a 4% rate of return, I suggest investing in U.S. Treasury bonds or even long-term CDs and minimizing your exposure to Fannie Mae debt (it might be impossible to avoid it altogether).

Also, keep in mind that only \$6 billion of our money went into U.S. stock funds last year. That means that if you move money into quality equities now, you will still be among the first individuals to do so. Tell your advisor you are nervous about buying, but you want some high quality investments in your portfolio and you would like a little more education so you can feel confident moving forward.

#### REFERENCES

- <sup>1</sup> [http://www.plansponsor.com/Bond\\_Funds\\_See\\_Record\\_Inflows\\_in\\_2009.aspx](http://www.plansponsor.com/Bond_Funds_See_Record_Inflows_in_2009.aspx)
- <sup>2</sup> [www.finance.yahoo.com](http://www.finance.yahoo.com)
- <sup>3</sup> <http://www.mbaa.org/NewsandMedia/PressCenter/71891.htm>
- <sup>4</sup> <http://www.bls.gov/news.release/cpi.nr0.htm>
- <sup>5</sup> <http://www.federalreserve.gov/newsevents/press/monetary/20091216a.htm>

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