VICTORIA
Capital Management, Inc.

FINANCIAL MARKETS PERSPECTIVE

JANUARY 2011

THE REAL SECRETS OF INVESTING

In October of 2000, as uncertainty of the outcome of the presidential election towered over the direction of domestic financial markets, an independent Victoria Capital Management, Inc. was “born” as a registered investment advisor in California. Over the past ten years we have manned the helm of our ship through rough financial waters. The 2000s will go down in history as only the second decade over the past eighteen where common stocks as a group fell in value. The decade also witnessed a virtual tie in a U.S. presidential election, a collapse of the high tech sector, terrorist attacks on the Pentagon and World Trade Center (and the Capitol if brave passengers aboard one plane didn’t foil the attempt), two ground wars in Iraq and Afghanistan and near Armageddon in global financial markets.

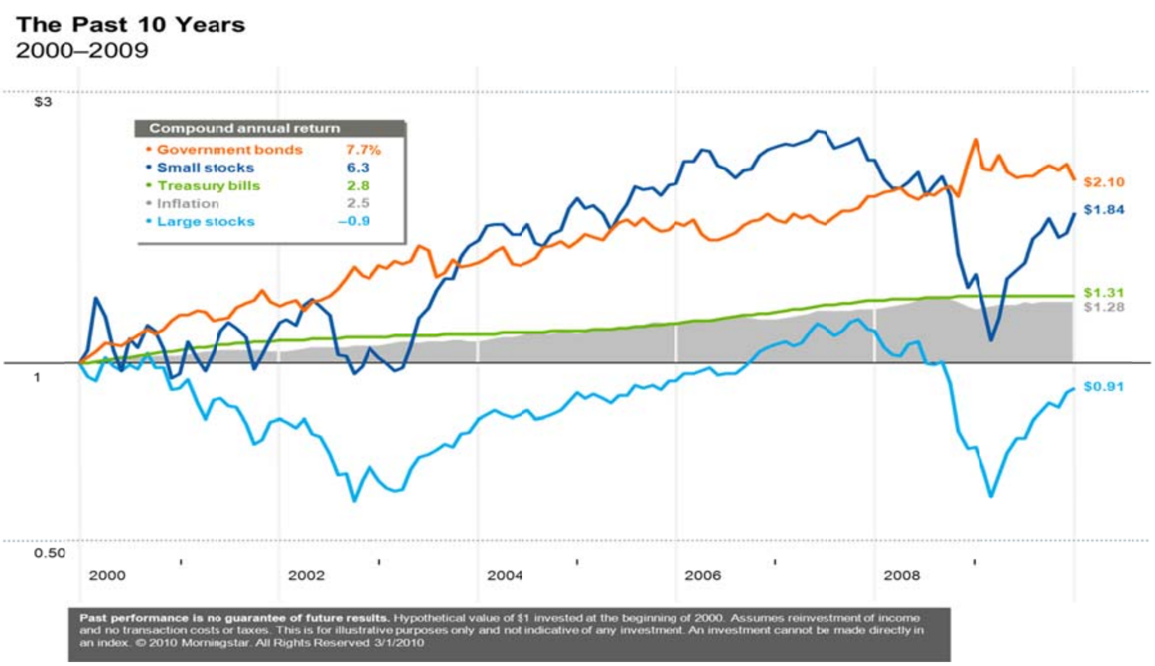
In the U.S., the financial crisis effectively eliminated private market financing for the residential housing market. As a result, residential housing remained in crisis mode with falling home prices and rising foreclosures. In Europe, the financial crisis revealed the prospect of national bankruptcies due to a breakdown in the ability of individual countries to sell bonds in the public market. (Since most European economies function on the Euro, they do not have the ability to solve economic problems by printing their own currency.) As 2011 began, the sluggishness of the recovery led to fears of individual state bankruptcies due to rising pension liabilities.

These events undermined some of the basic theories behind investing in financial markets. The traditional “buy and hold” strategy fell by the wayside after ten years of negative performance. For many investors who decided in the late ‘90s that owning stocks would result in easy gains found that their nest egg foundered for the next ten years. Some less aggressive investors were lucky to escape with break-even returns. Similarly, the adage that “you can't go wrong with real estate” was disproven as residential real estate prices crashed by over 50% in many heretofore attractive real estate markets. On the other hand, U.S. government bonds were the place to be with annualized returns of 7.7% -- well above the long-term average return.

The rush into common stocks in the late '90s was mirrored by the rush out of stocks during and after the bear market of 2008. Two years after the low point in stock prices, investors continued to liquidate holdings in domestic common stock mutual funds preferring to hold money market funds where yields were at or near zero or to risk the price volatility of bonds to receive a higher level of income. By the end of 2010, optimism for common stock investing had not returned to the masses who continued to avoid stock investments (based on cash flows out of domestic equity mutual funds) even after two years of double-digit market returns.

As Victoria Capital starts its second decade as an independent financial advisor, we are optimistic that the future will be more rewarding than the first decade of this century because decision makers at both the government and corporate levels are being forced to learn from their mistakes. For example, regulatory reform is leading to the prospect of less fraud and fewer Ponzi schemes that robbed savings from legitimate investors. Corporate executives responded quickly to the economic downturn and rapidly reduced costs in order to survive the 2008 recession. As the economy recovered, corporate America prospered and profits soared to record levels. The surprising rise in corporate productivity and profitability laid the foundation for the return of investors to common stock investing. As 2010 came to a close, individual investors began to be net buyers of common stock mutual funds, a hopeful signal that the stock market will reward investors as happened after the last decade of sub-par stock performance.

Exhibit #1



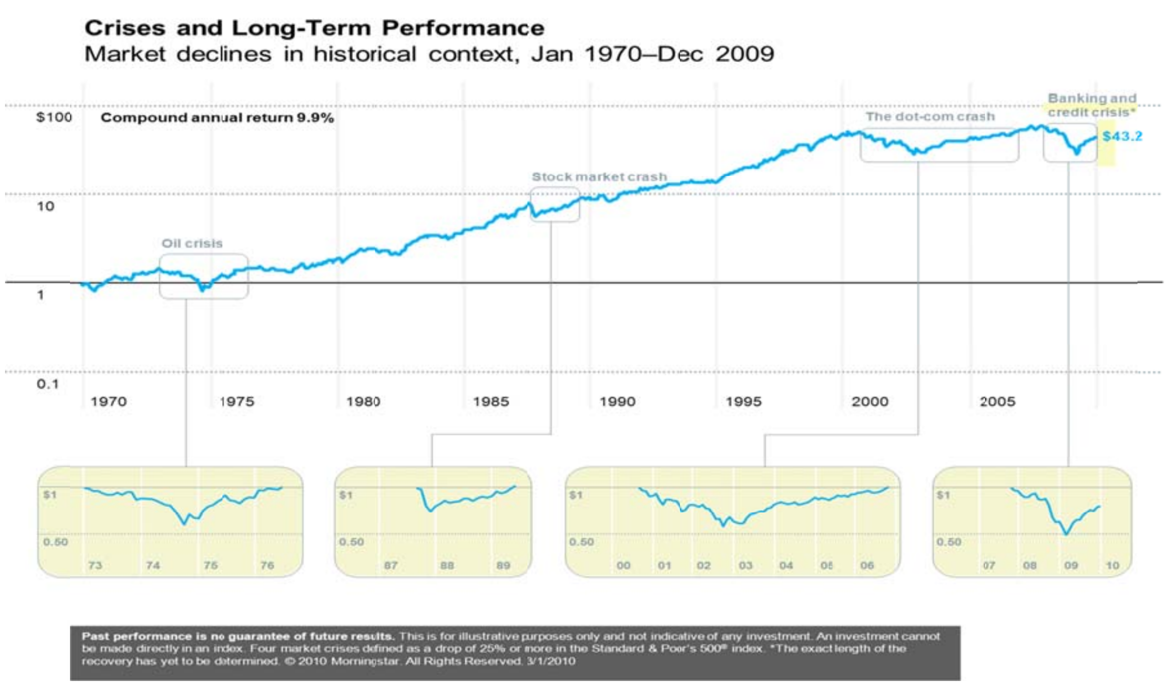
Courtesy of Morningstar, Inc.

Over the past ten years, fixed income market securities such as bonds and money market funds, usually considered to be the cornerstone of conservative investing, provided investors with a positive experience as bonds appreciated in value to a point where their total returns matched the historical returns from equities. (When interest rates decline, bond prices rise.) Since 2000, an investment of $1.00 in long-term government bonds was worth $2.10, a doubling in value where large company common stocks fell in value to 91 cents, a loss of almost 1%.

Another characteristic that differentiates bond returns from stock returns is the volatility in prices. As Exhibit #1 demonstrates, the progress in the bond market over the past ten years has been a lot less volatile (risky) than the stock market. For investors who have a long-term perspective, volatility provided for investment opportunity as buying stocks at low points increased long-term returns. However, for investors who have a short-term investment horizon, volatility can undermine the value of their portfolio.

Bond portfolio returns usually rely on the income produced and not bond price appreciation although, in a falling interest rate environment, prices of bonds can increase dramatically. On the other hand, stock returns are mostly dependent on price change that reflects future expectations for that company. Given that there are no promises for future prices of equities, volatility increases when certainty about the future diminishes.

Exhibit #2

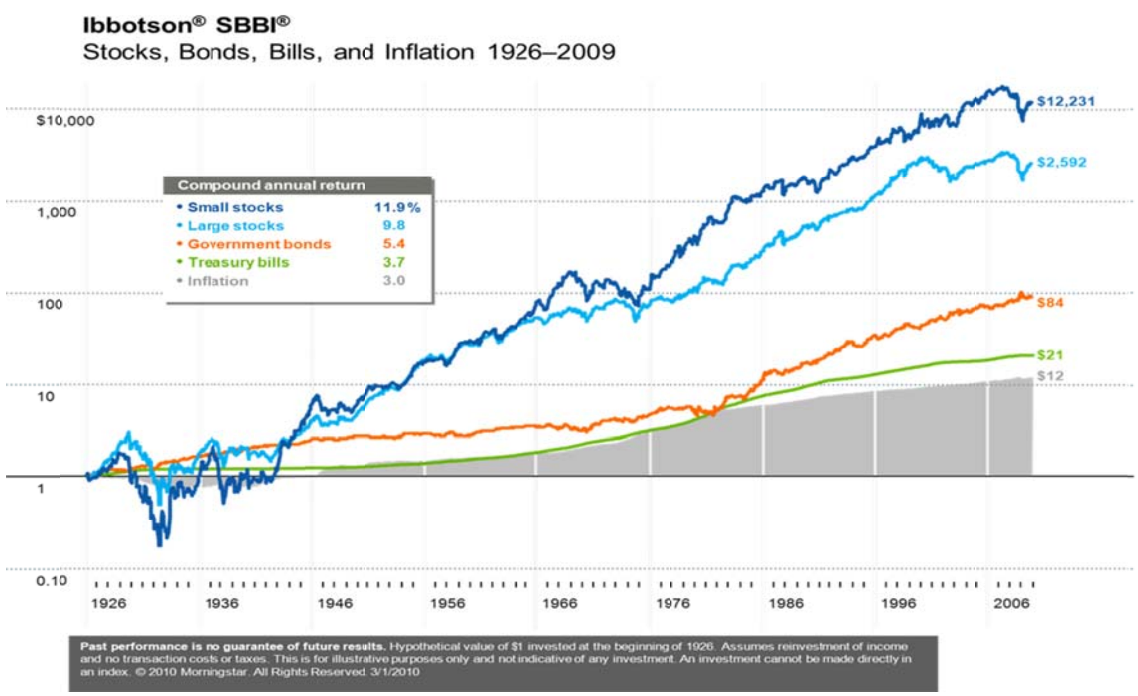


Courtesy of Morningstar, Inc.

The validity of this statement is demonstrated in exhibit #2 where historical crises are identified along with the level of stock prices during and after the crises. The smaller blocks at the bottom of the exhibit identify the time taken to return to a previous market peak. While break-even and beyond was ultimately achieved after the crises, the time taken to achieve that break-even was not easily predictable and varied greatly over time. If a short-term investor liquidated his or her portfolio at or near the bottom of these crises there would be a substantial loss. More to the point, if an investor, or more importantly a retiree, was living through these crises and was dependent on a fixed amount of money each month from these portfolios, the erosion in the principal value of the portfolio could have been substantial and might even lead to the exhaustion of savings during the investor's lifetime. On the other hand, a younger investor who chose stocks for long-term investment savings and did not need to withdraw funds experienced an annualized return of 9.9% -- the approximate return from stocks since 1926.

These performance excerpts from the recent history of financial market returns provide a clue to the real secrets of investing. Unfortunately awareness of those secrets won't guarantee a profitable experience even if investors recognize the role these "secrets" play in designing an investment portfolio. However this awareness can also lead to a better planning process that avoids the classic emotional responses of buying stocks at market peaks and selling them at market bottoms.

Exhibit #3



Courtesy of Morningstar, Inc.

These secrets can be generally classified into two broad categories: time and timing. Time relies on the basic mathematical concept of compound return: when an investment grows at a higher rate, the cumulative value of the investment increases faster as the length of time increases. The long-term value of investing in a diversified portfolio of common stocks is so significantly higher in dollar terms than other financial instruments that long term investors can usually weather the short-term swings even if those swings are substantial relative to other financial market investments.

In Exhibit #3 the cumulative value of a one-time stock investment reflects the traditional volatility of that portfolio. At a future point in time, the lowest downside risk of the stock portfolio value is well above the highest returns of various fixed income securities. Even though small stocks had volatile returns relative to Treasury bills over this time period, they still returned 11.9% versus 3.7%.

Another important distinction is investment timing. Common sense tells us that an investor who invests at or near the bottom of a market cycle will fare much better than one who invests near the top. All too frequently, investors' emotions lead to substantial buying at stock market peaks and panic selling at stock market bottoms undermining the ability for investors to benefit from the long-term characteristics of stocks.

The impact of timing on portfolio value is also heavily influenced by the characteristics of each investor. So far we have measured the prospective returns of an investor who makes only one initial investment. However, there are other types of traditional investors; one who is saving for retirement and one who is retired and requires a monthly income to meet living expenses.

Let's combine the ideas of time and timing in the following three examples to reflect and quantify some of the risks of investing.

If a person invests a one-time amount of $50,000 and holds that investment for thirty years, assuming a "zero volatility market" with returns of 10% each year, the accumulated return would be $872,470. However, supposing that person was invested in a market that went down 10% in each of the first two years but then averaged 11.6% for the next twenty-eight years (the equivalent of the 10% return over the period). This person's return in this "poor start" market would be exactly the same.

Let's take another person who is saving for retirement. Let's say this person starts with an investment of $6,000 and increases this amount by 3% per year over the next twenty nine years. In the zero volatility market, his account value would be $1,416,373 but in the "poor start" market, his value would be $1,820,999. The difference in market value is due to the fact that this person has little invested in those first two down years when the market fell in value but also benefitted from buying securities during a market decline.

For a person in retirement who has $1 million to invest and withdraws $60,000 a year for the next thirty years, the impact of these two market environments is markedly different. In a "zero volatility" market, he would have $3,285,670 at the end of thirty years, even taking out $60,000 per year. On the other hand, in the "poor start" market, the value of his savings portfolio would be zero—he would have depleted his account in the 27th year due to the fact that his portfolio lost a substantial amount during those first two bad years.

But let's say the "poor start" market is replaced with a "poor finish" market where the market value of the portfolio increases on average 11.6% a year for 28 years and then falls by 10% in each of the last two years. We know what happened to the first person with the $50,000 to invest at the beginning—he has the same $872,470. The second person who is saving for retirement actually fared the worst having $1,242,250 in thirty years—losing a substantial amount in those last two years. The third retired investor ended up with a whopping $5,079,294 because his portfolio grew at an above average rate during those first 28 years.

These examples highlight the fact that market volatility equates to short-term portfolio risk depending on the type of investor and the timing of investment. In these examples, the first investor had virtually no volatility risk although the portfolio did fluctuate in value. The second investor had some risk, but not so much that savings were totally at risk. However, the third investor—who was in retirement and started out with a substantial amount of money to invest—experienced the growth of his investment into a whopping estate or nothing—a risk very few savers are willing to take. Each of these investor's returns occurred during similar market environments and they were very different. The key to success or failure was how they invested and when they invested. In other words it was the amount of time invested and the timing of those investments that determined both the degree of success or failure.

There is a fourth investor who is a special case of our third investor. As opposed to the absolute distribution required for a retiree, tax exempt foundations pay out a specific percentage of the value of a portfolio. This approach increases the dollar amount of distributions in good markets and diminishes distributions in bad markets. This investment strategy eliminates the chance that the principal value of the foundation will be involuntarily depleted. In other words, a foundation can exist indefinitely. One strategy for a foundation would be to invest in those securities that produce the highest long-term rate of return. This approach can also be used by a retiree as long as income requirements are being met.

Conclusion

Financial market characteristics can produce a very different rate of return for investors depending on the mix of securities in a portfolio. In addition, the investor's time horizon and an accurate assessment of future market returns can be the most important aspects of implementing a successful investment strategy.

There is no easy way to weigh all of the factors that drive securities' prices. However, a systematic analysis of the risks associated with time and timing coupled with an investment strategy that incorporates flexibility into portfolio management should reduce portfolio risk and produce profits that are consistent with an investor's expectations.

Thomas E. Nugent
Chief Investment Officer

Diane V. Nugent
President

Victoria Capital Management, Inc.
4101 Main Street, Suite C
Hilton Head Island, SC 29926
T: 843-342-3044
www.victoriacapitalus.com