**WIAD Newsletter**

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**In This Issue**

- What I Am Thinking - Big Picture
- What I Am Doing – Stop Loss Orders
- Asset Allocation – Correlation
- November Investment Results

## What I Am Thinking - Big Picture

An unbelievable month. For the second consecutive month, the majority of equity and fixed income markets around the world ended in positive territory. As we've discussed in previous Newsletters, rising markets are always welcome, yet I remain at a loss to explain the market's global resilience given the economic data we are experiencing. In the past two months, it seems the worse the economic news that is reported, the more the markets went up.

With all that said, the power of massive central bank-provided liquidity is significant, at least in the short run. Financial assets almost always rise when cheap, fast money is available. However, with rates this low, the Fed does not have many bullets left. If the economy does not respond soon, all that will remain to beat the economy into shape will be the butt of the Fed's gun.

With the euphoria in the equity markets, I am puzzled by the recent policy changes in the bond market. I believe it is safe to say that the capital needs of the US Government will rise significantly in the near future to pay for 9/11-related disaster relief, and increased security, defense and military spending. I have no quarrel with these necessary expenditures; I just wonder how it is all going to be paid for.

With rates at historical lows, from a capital markets standpoint the US Treasury should issuing 30 year bonds and locking in these low rates for as much and as long as they can. Instead, in a surprise announcement, on 10/31/01, the US Treasury has announced that it is discontinuing the issuance of the benchmark 30-year bond for the foreseeable future. With this unexpected announcement, long interest rates plummeted as demand for the remaining 30-year treasuries outstripped the supply.

By discontinuing the issuance of the benchmark 30-year bond, the US Treasury has in effect artificially lowered long rates in an effort to further stimulate the economy. This stimulus will come in the form of lower long, fixed mortgage rates and lower long term borrowing costs for businesses. Homeowners and corporate borrowers should take advantage of the Treasury's largesse while it lasts. It won't last long.

This manipulation of interest rates in the long end could be the US Government's "gun butt" after all the Fed's monetary policy bullets are gone. Let's hope it is enough as the nation's future borrowing needs virtually guarantee the long bond will be back…

## What I Am Doing – Stop-Loss Orders

"Hindsight is 20/20"

Who among us can't say to some degree, " I wish I sold internet stocks in 1Q2000"?

While we are in different times in 4Q2001, the equity markets are still trading at relatively high levels given the recent disappointing economic data, negative corporate earnings outlook and the continued threat of possible terrorist acts on our shores.

As you all know, I am a firm believer in disciplined asset allocation and utilizing passive investment management strategies. That being said, when your investment policy and asset allocation plan is to maintain an exposure to equities, but your gut says the market (or a specific equity holding) is too high given the current world situation (or specific earnings outlook), don't lose any sleep.

Consider putting stop loss orders (to sell) on portions of your portfolio.

A stop-loss order to sell becomes a market sell order when the stock is bid at or lower than the specified stop price. Stop orders are generally used to protect a profit or to prevent further loss if the price of a security moves against you. Sell stop-loss orders must be entered at a price that is below the current market price. Stop-loss orders can be used with individual stocks or ETFs but cannot be used with mutual and index funds. The ability to use stop-loss orders is another advantage of ETFs over index and mutual funds.

With a stop-loss order, if the stock you think is too high stays in a trading range or goes up, nothing happens, the order goes unexecuted. If the market takes a meaningful move to the downside (due to war, unexpected bankruptcy, or other disappointing news), the stop-loss order gets you out at the next market price after the specified stop level is hit.

It is important to set the stop price at a level below the range of a stock's normal price volatility so you don't end up selling a position (and incurring the tax liability or benefit) that you didn't intend. The strategy of using stop-loss orders should be placed for capital preservation purposes in highly uncertain times. All other investment portfolio buying and selling should be done with the goal of asset allocation rebalancing or tax-loss harvesting.

While some might argue that putting stop loss orders on portfolio positions is tantamount to trying to time the market, I believe in highly uncertain times there are occasions when it makes sense to have a mechanism to take some money off the table and stop to think things over. On these occasions, an intelligently implemented stop-loss order strategy can prevent the dreaded "Shoulda, Woulda, Coulda" when discussing the state of the portfolio with one's spouse.

Stop-loss orders on internet stocks in 1Q2000? Where's a DeLorian with a flux capacitor when you need one?

**Asset Allocation – Correlation**

Most discussions on asset allocation initially focus on portfolio diversification. In my opinion, it is unwise to discuss portfolio diversification without a basic understanding of the concept of *correlation* and how it relates to risk and return.

There is more to portfolio diversification than just having a lot of holdings in a portfolio. Diversification can only decrease portfolio risk and increase portfolio return to the degree the asset classes included in the portfolio have *uncorrelated* historical return characteristics.

*Correlation* is a statistical term, used to measure the relative performance of two sets of historical data. For the purposes of our discussion of correlation, we will assume that the historical data we are comparing are the risk/return of different investment asset classes such as: bonds vs. stocks, domestic stocks vs. foreign stocks, or domestic large cap stocks vs. domestic small cap stocks.

In layman's terms, correlation measures how closely one asset class moves relative to another: asset classes that are positively correlated have returns that go up and down in relative sync; asset classes that are negatively correlated have returns that move inversely to one another; asset classes that are uncorrelated move randomly relatively to one another. The theory behind diversifying a portfolio with uncorrelated asset class returns to reduce risk is that when the return of one asset class zigs, it is more likely that other(s) are zagging to some degree, and vice versa. This zigging and zagging helps minimize

the volatility of a portfolio's performance.

Mathematically, the range of values for correlation can be from – 1 (perfect inverse relationship) to +1 (perfect direct relationship), where correlation value equal to zero indicates no relationship.

For example, a portfolio of 40 technology stocks is not a diversified portfolio. Some investors falsely believe they have diversified because they are holding many different companies. However, technology stocks in general have risk/return profiles that are highly and positively correlated, and thus a portfolio of this composition has the potential for very volatile return characteristics. Because of the highly positive correlation of the holdings, everything in the portfolio will tend to move up or down at the same time. This concentrated, high volatility strategy can be very good in good times, yet very bad in bad times.

On the other hand, a truly diversified portfolio composed of asset classes with low relative correlation will result in lower volatility and risk and more consistent return characteristics over the long term. A portfolio of this type might have holdings in technology stocks as well as other domestic equity sectors and management styles in varying capitalization categories. A well-diversified portfolio with uncorrelated asset classes might also include holdings in bonds, REITs and/or foreign stocks.

While the actual mix of asset classes in an investment portfolio will vary depending on an investor's individual risk profile, it is important to be aware of the concept of correlation and its importance in developing a diversified investment portfolio.

| **November Investment Results:** | **November** | **Last 3 mo** | **YTD** |
|---|---|---|---|
| NJL Equity/Income Aggregate | 5.48% | - 1.59% | - 9.59% |
| S&P 500 (including dividends) | 7.67% | 0.86% | -12.65% |
| Russell 3000 (including dividends) | 7.70% | 0.49% | -12.69% |
| MSCI World (in US $, price only) | 5.80% | -1.85% | -18.29% |

Note: The NJL Equity/Income Aggregate is a multi-cap global equity composite that is reflective of my aggregate investment portfolio's performance. The composite returns are comprised of over 98% global equities and cash and less than 2% domestic fixed income and include taxable and tax-deferred portfolios. The composite returns are unaudited and are calculated using AIMR Performance Measurement guidelines.

As we've discussed previous Newsletters, investment management is like the game of golf, the player who makes the fewest mistakes usually achieves the best score. The relative underperformance of the NJL Equity/Income Aggregate Composite in November is largely due to the large percentage of cash the portfolio is holding. Proceeds of tax-loss harvesting and asset allocation rebalancing strategies initiated in August and September were not immediately reallocated and as a result, some portfolio performance "slippage" occurred. While I felt justified in not reallocating this cash in the midst of all the poor economic data and earnings news in October, all I accomplished was proving, once again, ***that trying to time the market does not work.***

## Summary

With the Enron bankruptcy, I believe the Fed will use its eleventh bullet in December. While the energy trading concern is not under the Fed's jurisdiction, J.P. Morgan, Citigroup and others have at least $1 billion in unsecured loans to the off-balance sheet cowboys at Enron and the global financial system can't afford any crisis of confidence from a liquidity standpoint at this time. Going into the New Year, the world will be awash in liquidity. This is good for the markets in the near-term; the big question is: when will the economy benefit?

Not to beat a dead horse, but what happened with Enron is a good example of the usefulness of stop-loss orders the context of a specific portfolio holding. Other good examples would have been internet and technology stocks in early 2000 or REITs in 1998. On positions that seem irrationally high, put in a low stop loss order when everything is going well and forget about it. If you get filled, you will be glad you did.

With technology stocks leading the current market rally despite all the negative economic and earnings news, I worry that recent history will repeat itself and investors will load their portfolios with tech, more tech and only tech. True portfolio diversification is more important than ever. Maintain your asset allocation plan, and rebalance with discipline!

**Nelson J. Lam**
The Lam Group, Inc.
December 4, 2001

**Next Month:**

- More asset allocation
- 2001 Review

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