Where to Invest in 2007

By now, you have probably seen numerous articles telling you where the best places are to invest and make money in 2007. Some of these articles will direct you to invest in the markets of specific countries that are predicted to outperform all others. Others will offer advice on which asset class will perform the best in the coming year or on the winning allocation that you should have between stocks, bonds, and other asset classes, such as real estate or hedge funds. And last but not least are the articles that actually recommend individual securities, such as “11 Stocks To Buy Now” or “Top 6 Funds for 2007.”

What you will probably never see, however, is a magazine cover touting: “Oops! Our Top Stocks From Last Year Were Duds,” or “Mediocre Results From Our Top 5 Fund Picks,” or even “Best Emerging Market Idea Crushed By Currency Devaluation.” It is doubtful that these headlines would sell many magazines, neither would they inspire confidence nor foster high regard for the publication. At the very least, a report of this type would poison the well for future investment advice stories.

We do not advocate sticking one’s head in the sand when it comes to investments. Reading articles on investing and investments is a worthwhile use of one’s time, provided that the reader is endeavoring to increase his knowledge of the subject matter. In this regard, most financial publications do a good job, and hopefully the reader will be encouraged to further investigate ideas and concepts through more comprehensive sources. Increasing one’s understanding of the risk/reward tradeoff, investment products, and the styles and methods of investing should enable one to make better informed decisions for one’s own investments.

It is when investors follow the advice offered in these various “Where To Invest…,” or “Best Funds to Own…,” or “Top Stocks To Buy…” articles that they place their financial wellbeing in jeopardy. The main problem lies in the short-term nature of these implied recommendations. The uninitiated reader could assume that the article is offering advice on a winning investment strategy for the coming year. Taking action on such an assumption is often what separates an investor from his money.

> The stock market is a volatile animal. . . . There have been some traumatic declines in the stock market . . . even in good markets we have declines, and trying to predict its direction over the near term is an exercise in futility.
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> *—Peter Lynch, Q&A on Investing in Volatile Markets, www.fidelity.com*

Examine the Source

What can be so dangerous about following the advice offered in a well-respected, national publication? After all, these institutions have a reputation to uphold, and they certainly would appear to have access to vast resources and an institutional knowledge base. The danger is embedded in the business model of the publication: Magazines are in the business of selling magazines not managing money for investors. As such, they will publish articles that will sell magazines and ultimately advertising, which pays their bills. Since publications receive no fee

for investment results (with the exception of paid subscription investment newsletters, which are excluded from this discussion), performance is neither tracked nor reported.

So who are the writers of these articles? That is a good question. Perhaps several collaborators have contributed to the research and writing process. Frequently the writer(s) will employ the use of a computer model to select their stock or mutual fund recommendations. The author might be a seasoned financial reporter with decades of experience covering the securities markets or, just as probable, a newly minted 20-something journalism graduate who thinks that writing about investing sounds interesting. It is not uncommon for the writer to have absolutely no investing experience whatsoever. What is uncommon is for one of these articles to be written by an actual money manager.

If actual investment professionals were writing the articles, they would probably have titles such as “The Impact of Accruals on Earnings Quality,” or “Calculating a Normalized P/E Ratio Using Forecasted Earnings,” or “P/E Expansion and Contraction in Cyclical Industries.” These are hardly the attention-grabbing headlines that would be expected to sell magazines to the average reader. Moreover, professional money managers know that in order to make specific investment recommendations, they must first understand the specifics of the client’s financial position.

It would be absurd to assume that any publication could possibly know the investment objectives of each individual reader, so articles are correctly tailored to a one-size-fits-all approach. So what is wrong with a generic recommendation for the next “hot” emerging market, or several “must-own” stocks, or a few “stellar” funds for your portfolio? Absolutely nothing, as long as the reader understands the underlying risks and assumptions and considers each investment recommendation within the context of his total portfolio and his investment time horizon.

The Market’s Predictability

As investment professionals, we are invariably faced with this frequent line of questioning at dinners and parties: “Where is the market heading next year?” or “What’s the market going to do over the next few months?” Over the long term, i.e., greater than ten years, we feel reasonably confident in providing an answer that has a high probability of matching reality. But predicting the direction of short-term market movements is a matter of luck and chance.

> Absent a lot of surprises, stocks are relatively predictable over ten to twenty years. As to whether they’re going to be higher in two or three years, you might as well flip a coin to decide.
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> *—Attributed to Peter Lynch in One Up On Wall Street, on www.morningstar.com, Interactive Classroom, Course 507, Great Investors: Peter Lynch*

While the odds of correctly guessing that the market will be higher in the short-term are no better than a simple game of chance with only two outcomes, the odds of correctly guessing the direction *and* pinpointing the magnitude of such a move are significantly less.

Consider an article recommending the next "hot" emerging market. Crucial to investing in any emerging market are the risk assumptions about the stability of the political system, the level of government intervention in the markets, and the chances of a major currency devaluation, to name but a few. The professional emerging market investment manager will attempt to hedge some of these exposures or diversify a portion of the risk and will employ the use of more robust intelligence about these critical success factors. Not all of these factors can be measured.

Similarly, selecting which stocks to invest in requires taking certain risks. The reader who invests in a stock based solely upon the recommendation in an article is unwittingly making several major assumptions, such as 1) management is competent and shareholder friendly, 2) the company's business model is sound and will produce superior results in the form of increasing earnings and cash flow, 3) competitors will not be able to erode the company's position in the industry, and 4) the company's financial strength will allow it to weather any downturns in the economy or its respective industry.

At CornerCap, we mitigate the risks inherent in these assumptions by evaluating the company's balance sheet, examining management's track record of results, reading through the 10-Q, 10-K, and annual proxy statements, as well as assessing the industry dynamics and strength of competitors. Even then, success is not guaranteed every time.

> Well, I think the secret is if you have a lot of stocks, some will do mediocre, some will do okay, and if one of two of 'em goes up big time, you produce a fabulous result. . . . In this business if you're good, you're right six times out of ten. You're never going to be right nine times out of ten. . . . You have to take a little bit of risk.
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> *—Peter Lynch, Betting on the Market, Frontline's Interview with Peter Lynch, www.pbs.org*

It is a curious fact that most people want to know if now is a safe or good time to invest their money, as if those of us in the business are "in the know" and make this information available for the asking. One of the reasons that people ask is because this myth has been perpetuated by Wall Street upon investors for decades. In the traditional Wall Street business model, brokers are paid for transactions, not for performance. Therefore, an incentive is in place that encourages a short-term investment approach, and even if the results are unfavorable, people psychologically take comfort in knowing that they are following the conventional wisdom.

Conclusion

While we wholeheartedly applaud any publication that increases the knowledge base of the average investor, we disdain the notion that following the implied investment recommendations contained in headline-grabbing articles will consistently produce successful results. By this time, you have probably also figured out that this is yet another article from CornerCap extolling the virtues of a having a long-term investment horizon and that short-term investment strategies are really a game of chance, at best.

Returning to our opening headline, the CornerCap recommendation on "Where To Invest In 2007" is: "Follow the specific investment plan that was formulated to achieve your long-term investment objectives in accordance with your investment constraints, based upon your ability and willingness to accept risk, your need for long-term growth, your liquidity requirements, a long-term investment time horizon, the need for capital preservation, and any circumstances unique to your situation." It is safe to assume that this headline wouldn't sell many magazines either.