

CONTENTS

The Hospital As
Source of
Investment
Inspiration

More Restraint
than LBJ

Modern Portfolio
Theory at a
Glance

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The Patient Investor

Random, unconnected thoughts. That is what you get in the hospital.* Some thoughts make more sense than others. Some metaphors are compelling, others superficial. If a single thought makes sense to you, please attribute the thought to an insightful writer. On the other hand, if a point seems vague, disconnected—a real stretch—the fault naturally is not the writer's. It is the Demerol.

Telephones in hospitals are slippery and heavy, but very durable. Some users of telephones are slippery and/or heavy, but seldom durable. A good investment portfolio is durable. It outlasts its owner and its manager. The securities in a solid portfolio are high quality, and have long lives. The minimum expected life should be three years. Some of the securities should be heavy, like General Electric or Chevron, stocks with long, successful histories of contributing to our way of life. A few securities may be slippery, but not too many. A slippery security is an emerging company that produces something new and untried. Unlike the durable telephone, a slippery security might break if it crashes to the ground, but it also might produce stellar returns. A slippery security represents a low percentage of the total portfolio. Hence, if it slips off the table and crashes, the patient still lives.

In October I wrote about "immensely valuable advice," which is a uniquely powerful suggestion to a client by an adviser. The point was that advisers render only one or two momentous points of advice over decades-long business relationships. The following e-mail came in response:

"Some years ago, a fledgling investor of conservative nature hesitated when her account advisor, an old and trusted friend, encouraged her to expand her horizons by buying a well-known growth stock which was momentarily less popular than many others. Perhaps with patience wearing thin, the advisor told the friend, 'Just buy it. Five years from now you will thank me.' Sure enough, the stock now provides the largest single holding in the portfolio and the investor has been heartened as well as enriched by the experience. Thank you, John. That single careful as well as concentrated push was a great help."

So simple, but so important: Invest in quality. Then enjoy life.

*Between November 15 and November 20, I did battle with a gallstone in Syracuse, New York. The gallstone lost.

More Restraint Than LBJ

Around 1967, President Lyndon Johnson was sitting behind the White House when he suddenly lifted his shirt to show photographers a large surgical scar. The photographs of this big man with the big scar were slightly revolting, and I have wondered why he did it. Now I know the answer. You see, I want to show you my scars. I am like Dr. Strangelove. I resist because mankind does not want to see my scars. Nevertheless, the natural proclivity is to show all.

Have no fear. This issue does not contain a photograph of an investment adviser with his shirt up. Also, the adviser is not walking shirtless around the Circle. He has too much sense for that. He knows that most other people do not want to see the scars, something Lyndon Johnson forgot in an exuberant moment of uncontrolled energy. Nevertheless, temptation is there. After all, they are my scars. There are no others like them. They are works of art. Everyone should know about them. Right?

Thoughtful Wealth Planning&Management

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Visiting Hours

Important to the social fabric of a surgical floor is visitors, both relatives and friends. Some patients seem to have visitors all the time, while others appear to be alone. Some rooms are crowded with smiling, hand-holding guests who frequently ask how they can help, while other rooms are dark and quiet with little activity or social life. And so, I ask myself, what is the role of visitors? Do they help, or hinder? Whose need is fulfilled by visitation? The patient's, or the visitor's?

The answer necessarily falls between two extremes. One extreme is the patient visited by no one. The other extreme is the sick patient, lying on his back, looking up to a ceiling light he would prefer were turned off while five or ten visitors hover around the bed, smiling and laughing during

continued on page 4

Seeking Opportunity, Even When Pain Levels Are High

Hospitals are gold mines of investment ideas. Aggressive, creative companies constantly introduce new products and services that are used in hospitals. Sometimes, the products are profitable for investors in the manufacturer's stock. Here are two examples:

Hospital personnel use an enormous number of latex gloves. Some gloves remain on the user's hands less than a minute before being discarded to a special wastebasket. Use of the gloves increased after scientists recognized the AIDS virus. At the time, rumor has it, the gloves were manufactured by only one or two companies that then offered great investment potential for those who early saw the opportunity. Careful, though. The same opportunity might not be present today because supply has caught up to demand.

The Pyxis machine is another example of an investment opportunity. This machine was introduced

only four or five years ago. It is the delivery car on an electronic train. Nurses and doctors order specific pharmaceuticals that are placed into the Pyxis machine. When the pharmaceutical is removed and administered, the system automatically debits its inventory and the patient's bill. When inventory drops to a low level, the system automatically orders new supplies. The Pyxis company was very successful, and was acquired by Cardinal Health in a profitable transaction for investors.

Peter Lynch (former legendary manager of The Fidelity Magellan Mutual Fund and current television spokesperson for Fidelity) prided himself on the ability to see opportunities. He said that anyone can see the opportunities, but few do. Finding investment opportunities in the medical system is difficult because most of us do not seek opportunity when pain levels are high. Nevertheless, the opportunities are there. Seeing might require only a simple question: What's new, DOC?

Thinking Through Modern Portfolio Theory

I know that you have spent the last several weeks anxiously awaiting an explanation of Modern Portfolio Theory (MPT). You anticipate this treatise with the same passion as you await the release of the next Star Wars movie on May 21, 1999. Today is your lucky day, for I want to tell you about Modern Portfolio Theory, perhaps as a way of diverting myself from showing you my scars.

Unfortunately, MPT is not quite a theory. A theory is a clear statement of a concrete reality, such as “for every action, there is an equal and opposite reaction.” MPT contains no such precise statement. Nowhere can you read a rule that if you purchase X, then you will have Y result. The cause and effect relationship demanded by scientific principle is not there. MPT is not a prescription for profit. Instead, it is the compilation of a large number of associations that tend to prove that risk and reward are related.

“Wow,” you say. “Risk and reward are related. I can’t wait to read the rest of the story.”

OK. Sounds dull, but let’s go on. Prior to 1952, everyone knew or assumed that the greater the risk, the greater the reward. However, no one attempted to quantify the relationship. Students of investing wrote about the search for value without discussing inherent risk. The idea then seemed to be that if you acquired securities that appeared low in price relative to a measurable figure, such as book value or dividend yield, then your risk was low and your profit potential was high. While portfolio managers, students and writers actively sought solid measurements

of value, no one sought similarly precise measures of risk.

That changed in 1952, when an unassuming graduate student at the University of Chicago published “Portfolio Selection,” as part of his work toward a Ph.D. His name was Harry Markowitz. His work was the first to state that the important risk is the risk of an entire portfolio, not the risk of one or two stocks. That is to say, an investor’s financial life may not be negatively affected by the decline of one stock provided that other stocks in the portfolio are doing well.

Scientific minds, of course, constantly seek to prove and to refine. In the case of Markowitz’ work, elaboration required huge numbers of calculations. Risk had to be calculated compared to reward based on daily stock price and volatility statistics over many years. Even risk had to be defined. At a certain level of basic temperament, risk was defined as disaster: losing it all, and then some. The myth that thousands jumped from buildings in 1929 was part of the popular definition of risk. Yet this risk was meaningless. This was the risk of the speculator, the person who bet all on an unlikely prospect. Risk had to be defined statistically in a meaningful way over thousands of experiences. Markowitz used standard deviation, the measure of volatility around a mean.

Use of standard deviation implies that risk is volatility. By this measure, risk is neither downward trend nor realized loss. Instead, it is the possibility that an investor’s asset value will be low at precisely the moment funds are needed for tangible purposes, such as retirement, education or health expenses. Standard deviation does not define a trend. Instead, it measures variations around the trend.

For example, suppose that you have an unusual urge to walk across the River. Certainly, such an urge is no more unreasonable than my desire to show scars. You want to cross the river safely. Hence, you traverse the river at a point charts show as having a mean depth of three feet, a presumably safe depth provided that the current is not strong. You step off to the other side and, oops, you drown in a twelve-foot hole. You forgot an important point about mean depth. Mean is an average. It includes measurements of several inches as well measurements of many feet. You died because you stepped into one of the deep areas, instead of one of the shallow areas. You dummy. You would still be alive had you checked standard deviation, which would have shown you the danger. It would have told you that a significant number of areas across the river are too deep to walk. The bigger the standard deviation, the greater the magnitude (volatility) of measurements around the mean (trend).

The bigger the standard deviation of a stock (or of a market, industry, sector or country), the wider are individual measurements that make up the average trend. The trend could be up or down. You cannot escape the macro trend. But, you can acquire assets with lower standard deviations, meaning that your result will be less volatile than other results that make up the macro trend.

Why do you care? You want to make money, or avoid loss, right? Stick with me. There is more.

Markowitz’s work lit the fuse on a thirty-year explosion of research that was recognized in 1990 by the award of three Nobel prizes to

continued on page 4

Modern Portfolio Theory, continued from page 3

Markowitz and his colleagues William F. Sharpe and Merton H. Miller. Using the emerging power of computers, these men created new definitions and new concepts that are basic to the law and custom of modern investing.

Among their achievements was a new definition of volatility: beta coefficient, or just beta. Beta measures the volatility (risk) of an asset compared to the market in which it is traded. For example, a stock having a beta of 1.1 has been approximately ten percent more volatile than the stock market as a whole. If the market is up ten percent, we would expect a stock with a beta of 1.1 to be up approximately 11 percent. This concept appeared about 1963, and now is routinely presented by such statistical services as Morningstar, which computes betas on mutual funds, and Value Line, which computes betas on stocks.

Since beta is a comparative measure between an investment and the market, thinkers first had to define "the market." The need for this definition led to emphasis on indexes. With time, the most popular standard of reference became the Standard and Poors Index of 500 Industrial Securities. Other indexes appeared for bonds, small-cap stocks, securities of foreign nations and groups of foreign nations, as well as indexes of combinations of stocks and bonds. The most common use of beta is to measure a stock compared to the S&P 500.

The last great contribution of modern portfolio theory is the effi-

cient portfolio. The efficient portfolio is the ideal combination of assets, the perfect mix that produces greatest possible reward with minimum risk. Hence, if you have access to a sophisticated data base, you can choose either the desired level of risk or of reward. If you want high reward, say 15 percent per year, data will suggest that you must own only stocks of a certain character. On the other hand, if your reward ambition is 8 percent, the same data will suggest that you acquire a specified combination of both stocks and bonds that has the lowest beta (risk) for an 8 percent return. On the other hand, you could start your search on the risk scale instead. You can declare that you want low volatility, say a beta of 1 or less. Then you run your eye up the graph to the stated combination of assets that will give you the highest reward along the risk line you have chosen. Simple, right?

No, of course it is not simple. The average individual investor probably works best through intuition and common sense, especially since most individuals must contemplate the effects of income taxes, particularly imbedded, unrealized capital gains taxes. Individuals also must acquire securities within their "comfort zones," such as securities that they know personally or the securities of their employer. On the other hand, MPT has had a profound effect on institutional investing, giving rise to large consulting firms that help institutions to calculate the appropriate efficient portfolio and to allocate assets among available alternatives. Also, standards of fiduciary responsibility have changed. Prior to

creation of MPT, an investor was "prudent" if he/she, in a fiduciary capacity, acquired securities that were widely considered reasonable and prudent. Today, prudence is defined by process, not by selection. A fiduciary is prudent by following prescribed procedures, such as creating a written policy and a logical standard of diversification under that policy. Finally, MPT has affected individuals. Even though individuals might lack specific knowledge of risk/reward concepts, they still are aware of statistics like beta and of investment packages, such as index mutual funds.

That is enough about MPT. Let us now go back to the real world.

Visiting Hours, continued from page 2

a loud conversation that is irrelevant to his needs.

Fortunately, I was well-treated. Chichi was with me when I needed her, and my kids phoned at just the right moments. We also had visits from friends, including friends of my aunt and new friends that Chichi encountered while staying at Sarah House, a marvelous homelike residence for relatives of patients who live more than 50 miles from the hospital. If it is possible to say that a hospital stay was pleasant, then I can say that my stay was delightful.

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