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Portfolio Watch

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Fee FO Only®

Gourmet Investing

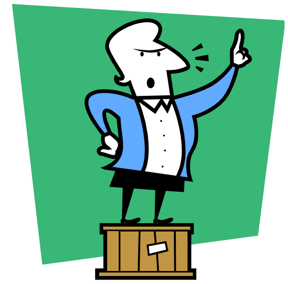
My nationality is Dutch, and if there's one thing the Dutch are not known for, it's their love of spicy food. Maybe I was adopted because I'm a fan of spicy food, but I certainly didn't learn it from what my mother used to cook. My mom regularly used something called a "pressure cooker," which has the ability to transfer flavors so that beef ends up tasting like carrots, onions taste like potatoes, and everything is some form of bland. Scientists still haven't figured out how this transformation works, but my mom loved it. Growing up, ketchup and pizza were considered exotic. "Normal" food was some form of meat, boiled potatoes, and vegetables that had been cooked just short of mush.

"Normal" investing

Those meat and potato meals were a lot like investing today. We are taught that the only normal or conventional investing is buying stock and bond mutual funds, and everything else gets labeled "alternative." In fact, *U.S.* stocks and bonds are the meat and potatoes. I guess that would make foreign stocks the boiled vegetables, and the idea of investing in emerging (i.e. growing) countries would be the hot sauce. OK for some people, but only in small doses. But who got to decide what type of investments are conventional and which ones are alternative? Clearly, it's the mutual fund industry. It started at about the same time 401K plans came into existence, and it has gained momentum ever since. It didn't hurt that for the first 20 years after the birth of 401K's the U.S. stock market had the strongest growth it's ever seen, along with an explosive growth in mutual funds. Companies like Vanguard and American Funds now control trillions of dollars, and have successfully labeled anything that doesn't fit in their product lineup to be alternative. The implication is that anything considered alternative carries more risk than conventional investing. It's just a name game and it's largely untrue, but it's been very effective.

Spicy, or just another flavor?

The goal of investing is to put money to work with the expectation of achieving a profit or positive return. How you do that doesn't matter. If I invest in a fund that finances the shipment of sesame seeds for McDonalds hamburger buns, that should be no less conventional than betting that stocks will go up. If I put money in a large-cap stock fund that takes active steps to limit big losses, why is that considered to be "alternative?" Alternative to what? Betting on stocks with no downside protection? That sounds a lot riskier to me, and in fact, it is. The "alternative" fund I'm thinking of has had one negative year since 1997, and has almost exactly doubled the performance of the S&P 500 in that timeframe. And yet, because it protects against large losses, it is categorized as alternative. Natural gas pipelines, real estate financing, equipment leasing, bank notes, taking any tangible steps to protect against loss…all of these have been labeled exotic or alternative. This makes no sense, and is an enormous victory by the mutual fund industry's marketing machine. Mutual funds have won the name game, and that makes it nearly impossible for most investors to get any kind of real diversification. Diversification requires investments that make money at different times and in different ways. If all of your investments require stocks to go up to be profitable, you have a portfolio that is about as interesting as pressure-cooked meat and potatoes.



Market Comments

Stocks jumped back up in April so that the S&P 500 is now back to where it was at the end of February. It seems as if the *expectation* of tax cuts and deregulation has now been baked in, so investors are waiting to see whether any of the expectations will pan out. If they don't or they take longer than expected, I think you will see the market correct very quickly. If we do get corporate tax cuts, lower regulation, and an increase in the limit of doves you can shoot on opening day, I'm sure the market will have another bump up. However, some or perhaps a lot of that bump has already happened.

Regardless of the short-term reaction to the latest government decision or lack of decision, I'm paying more attention to the Price-to-Earnings ratio of the S&P 500. The average PE ratio is about 25, which has only been seen twice…during the dot-com "irrational exuberance" days, and during the financial crisis. The PE ratio is a measure of how expensive stocks are, or how much investors are paying for company earnings. By historical standards the market is expensive, and the P/E ratio has a strong tendency to return to the mean. There will always be counter-claims by some people that stocks are cheap, but that comes mostly from people who are trying to sell stocks. Whenever market performance is measured with a starting P/E ratio above 20, the subsequent long-term performance has NEVER been good. Perhaps this time is different, but I doubt it. In the short-term anything can happen, but this is why I think some form of downside protection and lots of diversification is more important than ever.