REAL LIFE NEEDS ACTIVE MANAGEMENT

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Market Timing

It's All About Oil !

A few minutes ago our wire service made an announcement that the price for crude oil hit a new high of $48.20. Of course many are now saying that oil could stay in this area for the foreseeable future and even say it could go as high as $100 per barrel. What we find interesting about the current conditions is that although oil prices are at a new high, the iShares US Energy sector share is not making new highs. What this suggests is that traders believe current conditions are merely a short-term anomaly triggered by Fear. Fear of supply shortages caused by terrorism, the Yukos oil company scandal, and the non free-market minded Soviet leader Putin. Add to this volatile mix the Venezuelan election scandal and you have the makings of a mini-mania.

From a market perspective participants must continue to estimate the duration and general economic impact of higher oil prices. As you may know, the stock markets have made new yearly lows since we have been out of them. Investors have been trying to recalibrate profit expectations to account for the higher costs to manufactured goods and services. The trickle down effect is wider than one may first imagine, as oil is a cost of manufacturing for most industries from Airlines to plastics, Crayola crayons to Goodyear tires.

Higher oil prices spell lower corporate profitability. The question now is when will the markets start to discount the obvious and move onto the next part of the cycle. Once oil prices decline (and they always have after past crisis periods) there will be a commensurate increase in corporate profitability.

What this re-pricing means for us is the possibility that the equity assets we have been patiently waiting to purchase will soon halt their declines and start to show some price stability. Our patience has and continues to be rewarded, first, in that our accounts have not declined nearly as much as the averages and second, in that our large cash holdings will create the opportunities for strong capital gains once the dust settles.

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As a point of reference the TSE 60 is down 9 %, the Nasdaq is down 17%, the SPY is down 9 % from the '04 peak and the EFA is down 10.6%. Even the "safety" of a 10yr Bond has lost 6.5% of its value from its peak this year. Some of the sectors we have been watching for purchase are down from their 2004 highs by some 38 %. Thanks to not holding these investments over the last several months, we have missed out on almost all of these declines and are now close to flat for the year overall.

We have also been waiting with equal patience on a host of income generating assets including income trusts that have yet to correct enough to be considered low risk with meaningful cash flow. When the time is right to buy, these assets will provide both good income and capital gain potential.

If you are looking for a good book reaffirming the benefits and need for a market timing discipline, we recommend, Yes, You Can Time the Market, by Ben Stein and Phil DeMuth, published last year out of New York. Here are a couple of quotes to sample:

…Wall Street has been saying: you cannot time the market; buy stocks today, regardless of price, since stocks always go up in the long run. Our findings are exactly the opposite, and yet they agree perfectly with everyday experience. Far from being an irrelevant factor that we should dismiss from our minds when purchasing stocks, price appears to be an extraordinarily important factor that we ignore at our peril.

…Moving with the herd is psychologically gratifying and gives us a feeling of security—even if the herd is rushing off a cliff. Relinquishing this safety blanket is the emotional price that must be paid for getting outsized returns by Market Timing.

…The total return we receive from stocks is not just a function of the numerator: the money we get when we sell. Equally vital is the denominator: the price we paid, our cost basis. Buy into the frenzy of a market peak, when stocks are sizzling, and your money can cool its heels for the next two decades or even longer.

…the real reason valuation-based stock market timing lowers risk is because it lowers your cost basis, which means you have less chance of losing real money. There is less fear from falling stocks if you bought them when they were inexpensive. The risk of stocks is that you may drastically overpay and end up under water for a decade or two. Also, the Market Timer often has some money in risk-free cash, which lowers his downward risk profile. Market Timing is the difference between pricing stocks and throwing darts.

-Ben Stein and Phil DeMuth, *Yes, You Can Time the Market!* New York: John Wiley and Sons, 2003

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