



ROY A. HAMRICK, CFA

AUGUST REFLECTIONS

Recently, I've been pondering on the investment markets. Frequently I hear wise people admonishing us to expect low returns on our investments in the years ahead. In the fixed income arena, with yields on 10-year U.S. government bonds little over 4%, such comments seem justified – particularly when taking into account the negative impact of inflation. Yields on longer term bonds or of corporate issuers may be a little higher. But even to get to 5%, one has to go out decades or invest in securities with speculative elements.

No doubt these low return expectations lie behind much of the recent enthusiasm for hedge funds. Past returns on some hedge funds have been exceptional. Who wouldn't want to take advantage of them? I suspect, however, that most investors who jump on this bandwagon will be disappointed. The field has become too crowded, access to top hedge fund managers is too limited, and risks and fees are too high.

For most long-term investors, stocks and other publicly-traded equity securities remain the best opportunity. Yet even here expectations are not encouraging – perhaps only a couple of percent more than for bonds, and they entail considerable volatility and uncertainty. Furthermore, we are often reminded how difficult it is to beat the markets; that our best approach is to accept average returns by investing in index funds.

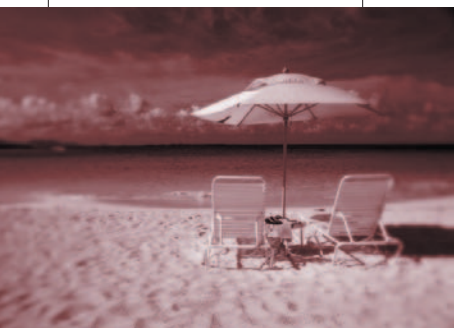
Is this the best we can hope for? Is the outlook really so discouraging? What's an investor to do?

First, I accept the notion that beating the market averages is a formidable challenge. In addition, I emphasize that it is critical to abide by the basic principles of investing: keeping risks well under control and maintaining good diversification are essential. Nevertheless, it makes sense to me if investors are not content with these low projected returns. I also think it reasonable to want to do better than the averages. Despite the challenges, I believe it is worthwhile to actively seek out stocks that might generate higher returns than those of the current low forecasts.

In order to do so, a favorable place to start is with underlying themes that form the basis for higher long-term returns. This is not the whole of it, and there are many other ways one might go about it. Nevertheless, I outline here three thematic approaches to investing successfully in stocks:

(1) Catching the Wave. In looking for good stocks to buy, a frequent approach is to identify an underlying trend that will drive above-average growth in a particular area. An obvious trend is that of the aging baby boom generation. Investors have been talking about this for years. Often this points towards investments related to healthcare or leisure industries.

There are, however, many other trends aside from demographics that may form the basis for successful investment ideas. Recent trends with regard to heightened security concerns or skyrocketing oil prices come to mind. Markets are quick to anticipate such changes, but if one can spot them before others do, that can lead to successful investments. For example, it seems to me that trends around the areas of taxes and accounting look advantageous. This is due in part to recent accounting scandals and increasing regulatory scrutiny, but also to the extraordinary proliferation of recent tax legislation and the needs of baby boomers who will soon be retiring.



There are various ways one might play such a trend – perhaps through companies involved with accounting software or preparation of tax returns. Clearly this is only the starting point for further investigation. Are such companies well run? What are their particular growth prospects? Have their stocks already run up in anticipation of such growth? To clearly identify such a trend is not the solution to the challenge of investment – but it’s a good place to start.

(2) Proactive Investment. This second theme that I highlight is different from that of anticipating what may be coming along. It is entrepreneurial and more suited to people who want to start a business, or have an idea for a product or service they think might take off. At its core, investing proactively means not simply identifying how the world may be evolving, but actively taking part in shaping what that future might be. This type of investment is often high risk with significant opportunity for loss. Sometimes it is highly rewarding.

For people who just want to invest in stocks or other securities, opportunities for this kind of investment are limited. The customary approach is venture capital, where one finances an entrepreneur who needs capital. Like hedge funds, however, venture capital funds are risky, illiquid and the best ones are difficult to access. A more liquid and readily available route – though still risky – is to invest in new companies or companies involved in entrepreneurial activities, such as biotech.

A more conservative way to invest proactively is to invest in large, well-established companies that have a history of identifying new products and services and successfully bringing them to market. Another proactive approach is to seek out stocks of companies that have new or progressive ways of conducting their business within established industries. Investing in these companies is a way of nurturing their innovative business practices.

(3) Noninvestment. The final investment theme I outline here is that of ‘non-investment.’ Though some may pursue aggressive strategies in this area, such as short sales, an investor can achieve attractive returns in a more modest fashion simply by avoiding companies in sectors that are likely to perform poorly going forward. People are often on the

lookout for the hot stock to buy. Investors may, though, serve themselves well by being astute about trends that point to areas of slow growth or decline that should be avoided. This includes reviewing the investments one currently owns and considering sale of those with poor prospects.

An example of this kind of approach with which we are currently working is evaluating companies whose business is heavily dependant on domestic U.S. consumers. In the face of higher oil prices, higher interest rates, loss of high-wage domestic manufacturing jobs and current high levels of debt, we suspect that consumer spending may slow. Therefore, we think companies whose products and services are heavily dependent on selling to domestic consumers may see declining growth. We are evaluating prospective investments as well as our clients’ current holdings on this basis.

★ ★ ★

These three thematic approaches – emerging trends, proactive investments, and areas to avoid – are only one part of a successful investment program. Once an investor has identified significant trends, one still has to determine which companies will be positively or negatively impacted by them.

Beyond that lies the challenge of financial analysis. A great company in a great industry may still be a lousy investment if its stock price more than fully reflects its prospects. Conversely, even industries with abysmal outlooks may contain strong companies with stock prices so low that prospective returns are advantageous.

There are no simple answers to the challenge of successful investment. Even if one identifies a great company in a burgeoning area, that doesn’t mean the investment will pay off. Still, in actively investing in individual stocks, perceptive identification of underlying themes and their potential impacts on specific companies can be highly effective.



6 September 2005

© 2005, Hamrick Investment Counsel, LLC. This newsletter is distributed for educational purposes only, and shall not be considered investment advice.

Despite the challenges, I believe it is worthwhile to actively seek out stocks that might generate higher returns than those of the current low forecasts.