September 30th, 2005

Hurricane season brought destruction to the South once again this year. The quarter ended September 30th brought us the devastation of Hurricane Katrina in New Orleans and a huge spike in energy prices. Despite this, our portfolios turned in their best quarterly performance of the year. In fact, for the quarter, our DEM portfolios gained roughly twice as much as the Dow Jones Industrial Average and the S&P 500 index.

Catastrophic events like Katrina demonstrate the wisdom of our buy-and-hold approach versus the foolishness of market timing. Rather than commit to the world's best performing asset class through thick and thin, market timers attempt to move money from stocks into bonds, real estate, commodities, or cash in anticipation of future events which could negatively impact the market. In theory, these speculators (not investors) are attempting to spare their portfolios from short-term losses. "Inflation will be high, so now's the time to move money into gold" they say. "Higher energy prices will be a drag on the economy, so bonds are the only safe bet." "Alan Greenspan is not finished raising interest rates so cash is the place to be until things settle down."

In theory, avoiding short-term losses may appear to be a prudent endeavor. However, in practice, market timing falls flat on its face for three very common sense reasons:

1) Future events are not predictable.

2) Even if future events were predictable, markets do not react predictably.

3) Disciplined, patient, long-term investors will amass a fortune in stocks over their lifetimes **without having any knowledge of the future**.

One would think that these common sense arguments, which grow more convincing with each natural, political, or economic disaster we face, would be more than enough to debunk the market timing theory altogether. But we are amazed at the number of people who continue to try to do the impossible.

To illustrate the point, suppose last quarter we knew with 100% certainty that a devastating hurricane would soon flood New Orleans and destroy virtually all of its offshore drilling operations? Suppose we knew for certain that oil prices would surge in the aftermath? Wouldn't a "prudent" advisor have acted on this knowledge and moved all of our clients' funds from equities into cash for the quarter? But had we done so, we would have missed out on the best period of the year in stocks. Only changes in our clients' financial plans warrant adjustments to our portfolios; not changes in our predictions.

Unforeseen events of all magnitudes occur every day. And the markets react. However, because neither occurrence is predictable, it is impossible to prevent short-term losses from either. More money has been lost by investors trying to anticipate market downturns than in any downturn itself. In fact, take the time to look back at the stock market over the past five, ten, twenty, and fifty-year periods. This long-term perspective provides us with all of the evidence we need to conclude that equity markets can (and will) temporarily **go down**. But the invisible hand of capitalism will never allow them to **stay down**.

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