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NEWSLETTER

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NEWS OF PEABODY RIVER

I have been much encouraged by the kind words and congratulations of friends and relations on the launch of Peabody River Asset Management. Although I have worked at small companies and startups for quite a few years, this is my first experience with a business of my own. Although I believe that my father had an entrepreneurial bent, he always worked for larger companies. My family has no recent tradition of small business. For me, despite many years in the investment management profession, the experience is comparable to leaving the established wilderness trail and setting off by myself into the woods with map, compass, altimeter, and extra food and clothing. I depend heavily on the guidance and advice of those who have passed this way before.

This is the first issue of my semiannual newsletter for friends and clients. Each issue will contain news of the firm, a brief look back at the investment markets, and, most important, an essay on investing. These essays are intended to be informative and to explain how I think about investing as I go about my practical business of managing portfolios.

I hope that this newsletter will interest friends who are not experienced investors, and also my friends in investment management who won't learn anything new from me, but who are curious to see how I present what they already know and think. If you would rather not receive this newsletter, please just drop me a note at aapt@peabodyriver.com. Even if it is of no great interest to you, I should appreciate your passing it along to someone who you think might enjoy it. Please let me know, also, if you wish to continue to receive it but only in electronic form. You can always download the newsletter, both current and past issues, from www.peabodyriver.com.

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this newsletter should be taken as a solicitation for business from anyone who is not a resident of Massachusetts.

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BRIEF REVIEW OF 2007

Looking back, we know that 2007 was a year of drama in the U.S. stock market. It didn't begin that way. We had been experiencing several years of very low volatility, and the first half of 2007 continued to be quiescent, until the subprime crises fell upon us in August. In a sense, things are back to normal. The U.S. stock market is once again volatile.

In the face of this considerable turmoil, the markets were very kind to us. Our portfolio was up 13.30% (including dividends and interest), which compares favorably with the total return on the S&P 500, which was up 5.49% (also including dividends). Our superior performance can be attributed in part to our having included emerging market stocks in our portfolio, and in part to our having maintained a large exposure to the energy sector. It ought to go without saying that past performance should not be regarded as a predictor of future performance.

Having just boasted of our return, we warn you that in future newsletters, we will explain how easily investors can be misled by performance numbers, no matter the honesty with which they are calculated and reported.

We do not publish statements concerning our outlook for the markets in the short term. Our long-term outlook continues to be that the U.S. stock market as a whole will return something between 7.2% and 8% per year, on average, before subtracting the effect of inflation. But there is considerable uncertainty associated with that estimate, and any given year could have a return that is very different from the long-term outlook. For our friends with taxable investment accounts, we warn that the return that you actually achieve will be reduced by taxes, quite possibly even in years when your investment returns are negative. And of course, any given portfolio or subset of the market may well have returns that are quite different from those of the market as a whole.

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ESSAY: HOW TO THINK ABOUT INVESTING

Benjamin Graham (1894-1976), the father of modern securities analysis and portfolio selection, wrote, "To invest intelligently in securities one should be forearmed with an adequate knowledge of how the various types of bonds and stocks have actually behaved under varying conditions..." Graham was a wiser investor than I, but I should add to his statement that intelligent investing also requires that one think about the process in a structural way (as he did), as if you were a scientist. Investing requires both knowledge and an intellectual framework.

Many people mistakenly think that investing, like life, is one damn thing after another. This limited outlook can manifest itself in either of two ways. On the one hand, it leads some to believe intensely that the proper way to invest is to pick stocks or other investments that

parade as winners—and lest I seem disparaging, let me add that picking investments that subsequently win is wonderful—and often to believe that these stocks can be identified in advance through intuition or cursory attention, which is a dubious proposition. On the other hand, it leads some into a sort of financial existential despair, and the belief that all investing is a gamble—once again, there is an element of truth here—with the consequence that they fail to take proper care of their financial assets.

When I say that an investor should think about the investment process in a structural way, I do not mean merely that she should have a “system.” To me, a “system” is the sort of gimmicky set of rules, founded more on blind faith than on analysis, that one might find in a paperback sold at airport newsstands to new arrivals in Las Vegas or Reno. Rather, one should have an explanatory model of why investments should behave as they have appeared to do or as you think they ought. This is the way economists think. It also helps to have evidence that the model can explain investment performance that occurred in the past.

Graham wrote the first edition of his second famous book, *THE INTELLIGENT INVESTOR*, in 1949, moments before the beginning of a revolution in finance, when economists began concerted efforts to wrestle with financial markets and financial instruments. (Graham’s first book, well known to all investment managers at least in name, was *SECURITIES ANALYSIS* (1934).) This revolution, one of whose principal products was what is often called Modern Portfolio Theory (MPT), has had profound implications for how professionals today manage gargantuan amounts of money. Modern financial theory, partly in recognition of its established status, but more because of its relationship to neoclassical economics, has become known (at least among economists, but not the public or even the investment profession) as “neoclassical finance.” After more than fifty years, Modern Portfolio Theory is far from modern, and we have also completed a circuit, but not a closed one, during which academically trained investment practitioners have rediscovered all the caveats with which the economists originally hedged the assumptions that underlay MPT and the rest of modern finance.

Moreover, even many financial economists, not to mention, of course, the more *au fait* investment practitioners, have rediscovered some of the virtues, or at least the virtuous investment results, of practitioners who have followed in the footsteps of investment analysts like Graham, like Warren Buffett.

The omissions and limitations of modern financial theory, however, provide no reason to revert to an earlier mythological approach to investment selection and portfolio construction. That would be much as if (to choose an analogy that is readily before us), because of Darwin’s ignorance of genetics and apparent inability to explain all aspects of life, we were to reject his ideas and to revert to a theory of life first developed in the ancient Middle East and dressed in the early nineteenth-century clerical garb of William Paley’s natural theology or “intelligent design.” The theory contains deep truths, even if its initial articulation was too simple, and it needs constantly to be put to the test and extended. And the founding thinkers were more careful than the textbooks that popularize their work.

In recent years, a more thoughtful challenge to neoclassical finance has come to prominence. It is known as “behavioral finance.” At its best, behavioral finance uses rigorous statistical methods to find ways in which individuals and financial markets consistently behave that are

inconsistent with neoclassical finance. It also reveals systematic errors of judgment that lead to poor results for investors. At its worst, it devolves into a sort of pop psychology and “just so” stories to explain supposed investment successes. In this form, it is used by some of the more unreconstructed traditional investment managers to spin plausible tales to justify their unproven investment methods to the public and their claims of being able to take advantage of irrational market behavior. The MIT economist Stephen Ross, in his spirited defense of neoclassical finance, counters the enthusiasts of behavioral finance with four objections:

- 1) Its observations are of effects that are generally small;
- 2) The statistical tests that it uses are suspect;
- 3) The effects it finds are fleeting and tend to disappear once they are discovered;
- 4) They are not easily used as the basis of a functioning strategy.

I may add that, in a sense, “behavioral finance” is a misnomer. All of finance, and for that matter, all of economics, ultimately concerns human behavior. All investing, even for the neoclassicists, fundamentally depends upon the ways in which human beings react to the prospects of rewards and risks. When the knowledgeable use the word “behavioral,” they refer to behavior that departs from *consistent rational* behavior. (Some therefore speak of “bounded rationality” instead of “behavioral.”) The greatest value of the field of behavioral finance for individual investors, therefore, lies not in providing special formulas that can help to “beat the market,” but rather in helping them to avoid common errors that produce worse performance than the market.

One consequence of thinking in a structural way about investing is to pay greater attention to the portfolio as a whole than to its individual components. It also allows us to compensate for some of the regular and irrational errors that researchers in behavioral finance have observed being regularly committed by investors. I will have more to say about this in future newsletters.

You ought at this point to know where I stand: My sympathies are with the neoclassical financial theorists. After all, I was educated in finance at the University of Chicago. But I have been an investment practitioner for more than twenty years, and I temper theory with experience. And in handling the portfolios of individuals, I am tilling fields where the theorists, in their ideal and perfect shoes, have feared to tread (at least until the last few years) but investment advisers have been laboring throughout modern history. This is why I emphasize the importance of the structuring of portfolios. You will seldom find me bloviating on the performance of individual stocks. Even Benjamin Graham, writing before the advent of modern portfolio theory, asserted that the concept underlying his approach to security selection, which he named “margin of safety,” is logically connected with the principle of diversification—in other words, portfolio construction.

You may think that I am addressing esoteric disagreements among investment practitioners that have little relevance for your portfolio. But these ideas have practical consequences. There are both subtle and broad disagreements among investment practitioners, and some of these most assuredly have relevance for your own investments. John Maynard Keynes famously wrote that “Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist.” Practical investors

who fail to think systematically about what they do are usually the slaves, too, of some defunct investment commentator.

And why am I telling you this, and what are the practical consequences for you, the investor? If all that mattered in investing were the selection of winning stocks, all of us should be holding the same set of stocks. All our investments would be alike. But they are not, and they should not be. As I have emphasized in this essay, what matters most is the structuring of the portfolio. And the portfolio should be structured to suit the investor. As an investment manager, I manage each portfolio to fit the particular objectives and circumstances of my client.

In coming issues of this newsletter, I will define and discuss investment terms that you may have encountered (and perhaps seen abused), like “value,” “growth,” “alpha,” “beta,” and “derivative.” I will explain investment returns, the risks inherent in investing, and, perhaps most important, the tradeoff between return and risk, which is the hard center of intelligent investing.

As I do this, you will see me working out what I mean when I speak of a structural approach to investing. I hope that my commentary will lead you toward a realistic view of what investment returns you can expect, and to see that there is little reason to despair. In the long run, and managed intelligently, your investments will probably serve you well.

The next issue of this newsletter will consider the concept of *return*.

Adam Jared Apt, CFA

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