



ASSET MANAGEMENT COMPANY

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INDEPENDENT,

FOCUSED

INVESTMENT

MANAGEMENT



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INVESTOR BEHAVIOR AND IMPROVING RETURNS

SUCCESSFUL INVESTING REQUIRES a rudimentary knowledge of at least some of the cognitive biases to which we are all prone. Think of it this way, pilots flying in the clouds can get vertigo and need training to rely on their instruments and ignore what their inner ear is telling them about aircraft position. Similarly, investors need to be trained to ignore certain traps and to rely on rational decision-making.

Here's a quiz to test your awareness and vulnerability to some of these biases:

1. Two investors, Mr. Bad Luck and Ms. Good Luck, both bought stock in ABC Company. Mr. Bad Luck bought at \$65/share and the price then fell on bad news to \$20/share at which point Ms. Good Luck bought. What should these investors do?

- Mr. Bad luck should wait to sell until the stock goes back up to \$65 so he doesn't lose any money; after all, he only has a paper-loss so far.
- Both Bad Luck and Good Luck should sell; a stock that's dropped that much is likely to drop more.
- The market has no memory and doesn't care at what price Mr. Bad Luck purchased. Both investors should examine the merits of the stock based on its current price, and ignore past price moves.

2. Everyone seems to be selling stocks—even stocks that you have just bought at what should be cheap prices. You should:

- Sell now, before prices go down even further. There must be a reason everyone is selling.
- See that the description of “everyone”

selling is illogical because for every seller there is someone who is buying. If the stocks you own are trading at reasonable or, better yet, very attractive prices, it's likely to be a great time to add to your positions, particularly if you have a long time horizon and there appears to be a panic or herd mentality prevailing.

c. Immediately turn on CNBC and heed what the strategists are saying.

3. You hear of a “hot” new IPO and the stockbroker is telling you that this deal is a “no-brainer.” He guarantees you are going to make a lot of money in the short term. You should:

- Buy some, after all, you've heard that people can make huge profits in IPOs and it is very hard to get in on them.
- Immediately subscribe to the offering because investment bankers and brokers are great sources of objective information.
- Dismiss the notion that there is anything like a guaranteed way to make money and make sure you are on your State's DO NOT CALL list.

4. You are a beginning investor and the first three stocks you buy—which happen to be in companies you like—go up in price. You therefore conclude which of the following:

- Investing is pretty easy; everything I touch turns to gold. I'm going to get more brazen as my confidence builds.
- These Internet stocks are the place to be; Warren Buffett doesn't understand technology investing, but I do.
- I should be careful because feedback loops, particularly in the short term, are unreliable in investing. I may have just gotten lucky.

5. Janice Liftop just inherited \$10 million. She should:
 - a. Immediately go to Las Vegas with 3 of her best friends to try and double her money.
 - b. Buy her \$10 million Red Mountain dream house for cash.
 - c. Call her friend's broker in Florida because he has a riskless way to make 15% per year after taxes!
 - d. Hire an independent investment advisor who will help her develop a long-term plan and avoid many of the pitfalls in investing.

For more on behavioral finance, visit our website: www.obermeyerasset.com

(Answers: 1. c, 2. b, 3. c, 4. c, 5. d)

*To understand
that Wall Street
exists solely to sell
investments to the
public is to advance
much further toward
investing success. 🌿*



PROSPERITY BY REFUSAL

John Goltermann, CFA, CPA

IN THE CAVEAT emptor investment world that we live in, it pays to know the details behind any investment being considered (read, risk) and to ignore the carnival barking of Wall Street firms and TV commentators.

Wall Street has a long record of success at setting out traps to catch unwary investors and survival depends on the ability to see those lures for what they are. Many of those lures rest in the financial statements issued by managements who use accounting mechanisms to overstate the economics of their business. Other lures rest in the rating system of Wall Street analysts, and in the conflicts inherent in how investments are promoted. To understand that Wall Street exists solely to sell investments to the public is to advance much further toward investing success.

Warren Buffett once said that the ability to say “no” is a tremendous advantage to investors. Exercising this ability can be one of the best routes to excellent returns because it will help avoid bad situations and unfriendly managements.

For example, in 2001, when Cisco was announcing terrible sales and earnings, its CEO blamed the company’s troubles on a “100-year flood.” This announcement came after he had personally cashed \$156 million in stock option profits. Did the CEO see this storm coming and keep it to himself while he exited the stock? Why didn’t he warn the public beforehand? Yet this particular CEO remains in place as leader and chief shareholder advocate of a company that lost 7 times as much shareholder wealth than Enron did from their respective tops.

I don’t recall one prominent Wall Street analyst, or media pundit that ridiculed the “100-year flood” explanation. I didn’t read a single article that focused on the option exercise. I didn’t witness any outrage over the fact that Cisco’s stock option program cost about 10 times as much as the company earned during its boom time (July 31, 1998 through July 31, 2001). And most importantly of all, the “100-year flood” excuse was the most modest economic downturn since World War II.¹

Did Cisco’s CEO do anything illegal? No. But, we can also choose not to invest in the company.

Company managements are not the only group who can be ethically challenged. By now, many understand the conflict of interest that investment banks face in their rapacious quest to generate fees. In this quest, “Buy” recommendations came to outnumber “Sell” recommendations 200 to 1 by the end of the 1990s.²

On the surface this ratio seems absurd because for every buyer there must be a seller. But two reasons caused it: 1) Institutional clients of the firms who publish research are in a position to punish the brokerage firm if they were caught unaware in a selling downdraft from a ratings change; and 2) The “Chinese Wall” (the supposed separation of investment banking operations and research analysis) can be mighty porous. Not only did investment bankers lean on analysts to say nice things about existing clients, but they demanded good recommendations for potential clients as well.

By knowing how the odds are stacked against investors, we can separate hype from the truth, and seek out important details (which are often buried in footnote disclosures). Prosperity will be enabled by avoiding large losses, which often requires us to say “no” to the barkers and the shells of the investment world.

¹ Source: Bloomberg GDP Data 1940 through 2004

² Source: Donald Cox. *The New Reality on Wall Street*. 2002.



WHAT A WEAKER DOLLAR MEANS FOR YOUR BOND INVESTMENTS

Roger Hennefeld, CFA

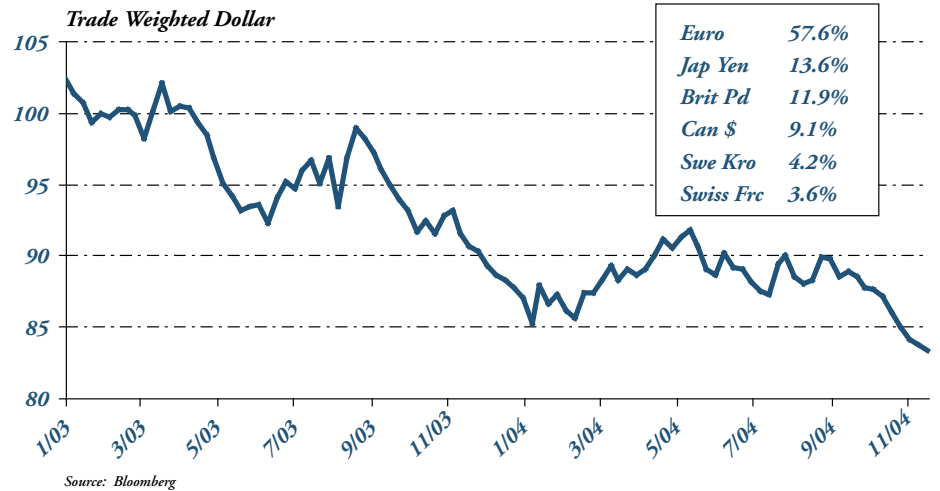
THE U.S. DOLLAR IS currently mired in a steep decline against most foreign currencies (see chart below). This trend, primarily caused by an increasing U.S. current account deficit, will eventually force foreign investors to reach their limit in their desire to finance our country's deficit spending. These foreign investors will eventually diversify into other currencies and/or demand higher U.S. interest rates.

Higher U.S. interest rates will then depress prices on many investments, particularly longer duration bonds. For this reason we currently tend to invest our clients' fixed income dollars in shorter duration instruments. While the yield may be lower, we believe that protecting principal and reinvesting as interest rates trend higher will produce better long-term returns. In addition, as the Federal Reserve raises the Federal Funds rate, our clients

benefit quickly by earning a higher return on their short-term investments.

Another way we are capitalizing on the dollar slide is by investing directly in high-quality foreign bonds such as Canadian treasuries. These investments benefit directly from a declining dollar and can serve as a good hedge in a bond portfolio. Canadian treasuries have the additional benefit of a slightly higher yield to maturity than comparable U.S. treasuries.

Besides a weaker dollar, we continue to pay attention to other factors determining interest rates. These include inflation expectations, current monetary policy, the domestic job situation and overall U.S. economic growth (GDP). Please feel free to contact us anytime to discuss these topics in detail and how they might affect your fixed income investments.



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