

April 14, 2009

I have a pair of Skyline 16x50 binoculars that belonged to my father-in-law, Conley. They feel great hanging around my neck or in my hands (certainly due more to my fond memories of their former owner than the superior design of their manufacturer.) Even though they are decades old, the magnification and width of field are superb. There's just this one tiny problem: they create just enough double vision that you have to close one eye when you look through them. I still remember having to use them as a *monocular* so I could see Sam Snead lay up close to the pin on the 18th green at Sedgefield Country Club when Conley and I would go to the Greater Greensboro Open.

A while back I tried fixing my binoculars' cockeyed view. Perhaps an objective lens or eye piece was cross threaded. Nope, they were screwed in fine. Asking myself "what's the worst that could happen," I took them all the way apart. Four tiny screws later, cover plates removed, I saw the problem: there were four prisms, seemingly held fast with little set screws, until one prism jiggled loose. Just one misaligned prism resulted in the distorted view.



I was reminded of my binoculars after an attorney friend of mine told me about a presentation he's been giving to area banks. He's committed to helping them work through this financial crisis and see the future of banking. When he talks, he holds a prism up high. He tells the bankers, "If you look straight ahead, where you're accustomed to looking, you won't see what's straight ahead. If you want to accurately see what's ahead, you need to turn the prism."

Many of the troubles we're experiencing in our economy are due to our nation's tendency to look straight ahead and miss it. For example, we saw that Lehman Brothers was leveraged 25 to 1 while many investors and talking heads didn't blink an eye because that's how investment banks have always operated. And for years consumers shunned saving, but rather lived on their home equity and credit cards because their home value always went up and cheap credit was always available. And in the last year, we saw that a bank could combine a few BBB issues into a new CDO and the rating agencies would suddenly call it AAA because it is a new security that was "relatively" safe. On the surface, these examples might look like instances of *hindsight* being 20/20, but they are really instances of *past foresight* being more like 20/180.

I wish we could say that, as advisors, our vision has always been stellar, but we can also be guilty of "looking straight ahead and missing it." What is more important, though, is that we're willing to open up the binoculars, adjust the appropriate screws, and go on viewing the golf match. We think the only thing worse than looking through a broken pair of binoculars would be to think either: a) we'll get lucky and the golf ball might just roll into view or b) the binoculars are going to fix themselves.

So, what prism tweaks have we set into motion? They can be summed up in six areas: Price, Moat, Uncertainty, Dividends, Diversification and Safety. We'll give some details of the first three in this commentary and the next three in the following commentary. If you can't wait until next quarter to hear about them, let us know and we'll send you our thoughts ahead of time, or we can sit down and talk about them face to face.

128 E. Fisher Avenue | Greensboro, NC 27401
☎ Office: 336-272-9488 | 📠 Fax: 336-272-2654 | ✉ Email: info@jonathansmith.com
www.jonathansmith.com

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For years, Price was our (and many other value investors') end-all, be-all. We've been intent on buying "dollar bills for 50 cents." The focus in this approach is more heavily on the *stock* and less heavily on the *business*. The problem is that this approach alone can lead to casualties if the investment's time horizon and risk tolerance isn't aligned with the investor's time horizon and risk tolerance. We are still like a budget conscious grocery shopper: we know that it makes sense to buy cheap produce that has a few bruises on it, we're just also conscious of some other factors that should get equal weight.

Moving up our chain of importance is a focus on a business' economic Moat. Warren Buffet said that a moat protects a "valuable and much sought after business castle." Moats can come in many forms such as a well-known brand name, superior pricing power, or a large portion of market demand. While they come in many forms, all moats contribute to a common result: a company that is more likely to be in control of its own destiny. We recognize that there is plenty of money to be made in businesses *without* moats (many of us have built our livelihoods working for "no moat" companies). However, in this environment where the rules seem to change daily and confidence is here one day and gone the next, we believe it is wise to limit the number of factors that are outside of the business' control.



Another area garnering more weight in our process, is our level of Uncertainty regarding the potential value of an investment. When I took up softball in my early forties, having never playing baseball as a kid, my batting philosophy was this: close your eyes and swing, repeat if necessary. In investing, we have a more control over the certainty of outcomes than I did in the batter's box. Before we invest, we can choose to swing for either "homeruns and strike outs" or "singles and doubles". Granted, sometimes swinging for singles and doubles will end up in a homerun and sometimes it will end up in a strikeout, but most of the time it'll turn out just as intended: singles and doubles. Since our primary job is to help our clients sleep well at night, we are inclined to invest where we have a low degree of uncertainty about the potential outcomes.

The most frequent question we've heard after talking about any tweaks to our investment strategy is "isn't this like shutting the barn door after the horse is already out?" It's a great question; one we've thought through extensively. Our best answer is this: if someone would ring a bell today and announce with 100% certainty that the stock market can't go any lower and we'll have full recovery within months, then we would invest differently. The reality is that we haven't heard any such bells announcing anything of the sort and, frankly, we could still see more unnerving news on the horizon.

We still think that today is a great time to own U.S. equities, particularly the companies that have the qualities we mentioned above (historically low prices, sizeable moats, and low uncertainty.) The potential returns we could see over the next ten years could be at levels not seen in generations. The problem is that ten year time horizons are hard to come by and even harder to stomach. This brings us again to the other three "prism tweaks" that we'll cover next quarter: Dividends, Diversification, and Safety. These three allow us to (respectively): get paid to wait, smooth out the bumpy ride, and seek superior risk-adjusted returns. Again, our primary job is to help out clients sleep well at night and now more than ever that means both investing for the upside and protecting for the downside.

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