

Excuse me, but could you please downgrade my room?

The offer was too good to refuse. A few weeks ago, I enjoyed a free stay at Greensboro's newest, most sought after "hotel" in the heart downtown. [All I had to do](#) was bring my own sleeping bag and make sure none of the eleven homeless men sleeping in the next room smoked anything during my 1:00 to 3:00 am watch. And although I was a bit groggy the next day, I still gave Grace Community Church's Winter Emergency [\(WE!\) Shelter](#) a five-star review.

My highlight was talking with Jeff (not his real name), the only overnight paid staff person at our church's meeting-hall-turned-shelter. As the worn and weary men bedded down in the next room, Jeff and I talked football and he started to open up. I learned that up until three years ago, he had been living on the streets, in cars and in shelters for twenty years. By the time you read this, Jeff, who had used every drug known to man, will celebrate two years of sobriety. He no longer spends his extra \$20 getting high. His most recent purchase, rather, was two hours of Algebra tutoring so he could pass his online class at [Phoenix University](#). Talk about [reallocating capital](#).

When I woke up at 1:00 am for my two hour night watch shift, I had a lot to think about. I had heard that one of the top three New Year's resolutions is to get financially healthy, along with losing weight and quitting smoking. For some, that means getting out of debt, for others it might be drafting a budget or increasing retirement contributions. The fact that so many people make resolutions, and that they lump financial goals in with smoking and weight loss, says a couple things about us: 1) We have a desire to do things differently financially, and 2) Change is hard.

Maybe it was too personal, but I had asked Jeff how he changed. How did *he* move from a perpetual cycle of self-defeat to what he termed "real life?" And perhaps more to the point, how would one of these snoring guys on cots in the next room do it? Jeff spoke for hours, went on plenty of tangents and used a few words I can't repeat here. But in sum, he said all it took was **Remembering Heartbreak** and **Knowing Yourself**. And while your and my New Year's resolutions don't quite carry the weight of "stop being homeless," these two change agents are powerfully relevant in the *personal finance* realm and in [what we do](#) at Jonathan Smith & Co. on the *investment* front.

Personal Finance – Remembering Heartbreak

The event in Jeff's life that led to change wasn't a stint in jail (though he had plenty) or a sub-freezing night on the streets (he had many more of those). Rather it was when Jeff became aware that he had disappointed and hurt a loved one. He didn't volunteer details; he just said he remembers that heartbreak whenever he's tempted to go off track. One exercise we do with clients is to project waypoints 5, 15, 30 years into the future and ask "If nothing changes and we go out 15 years, where will we be?" There might not be heartbreak now, but for some, if things don't change, it will surely come. We detail what heartbreak would look like and outline a course for sustainable change.

Personal Finance – Knowing Yourself

I got a little nervous when Jeff put a stack of twenties on the table, but he was making a point about himself. Twelve months ago, Jeff said, that much money would have made him want to go out and do something destructive, so he would have to keep it "buried" out of reach. Similarly, one client of ours has paid his credit card bill off several times, only to see it creep back up to \$3,000 over and over. He quit fighting it and now his \$2,000 credit card balance serves as a governor against unchecked purchases. The annual interest charge is a small price to pay compared with the frivolous spending that would always follow if he had a zero balance. Invariably, our sustainably successful clients are not the ones who earn or have the most money, but those who know themselves, know what they are really saving and investing for, and set up their lives accordingly.

**Investing – Remembering Heartbreak**

Jonathan keeps a quote from a client on a yellow sticky note above his desk, "I can't afford to lose this. I don't have the ability to replace this capital. I don't know how much further I can stand this." It's dated March 3, 2009 *three days before the market's bottom*. One precipitant of the unparalleled increase in market volatility over the last two years

is that investors have forgotten this heartbreaking feeling. Absent this valuable reminder, many take on more than appropriate risk to make up for “lost time” and have to learn all over again the basic principles of risk and return.

We wrote in [last year's Q4 commentary](#) that we were increasingly cautious. Investors had experienced a drought of what we call “worst days,” or the bottom 200 days in the market in the last 83 years. We believe this drought led investors to take on undue risk and we expressed concern. Not surprisingly, we had 5 “worst days” in 2011 (versus 1 day for 2010 and 6 days for 2009). And while we don't want to be irrationally governed by fear, we are students of history, and heartache, and we know the future holds more heartache at some point.

Investing – Knowing Yourself

In his book [Your Money and Your Brain](#), [Jason Zweig](#) describes a study that analyzed the MRI brain scans of two individuals. One person was expecting an immediate monetary gain versus another, a drug addict, anticipating a hit of cocaine. Surprisingly (or not) the images were near carbon copies. The siren call of financial gain is loud and overwhelming, but money does more harm than good if it is invested in ways that won't get an individual safely home...or worse, if the investor isn't quite sure about the capital's real purpose. We keep this front of mind by reviewing our allocations and ensuring they align with our risk/return expectations, the current market climate, and most importantly our clients' goals. Gambling legend [Walter \(Puggy\) Pearson](#) was a professional poker player and 1973 World Series of Poker World Champion. He once said “The first thing a gambler has to do is make friends with himself. A lot of people go through the world thinking they're somebody else.”

The value of a good night's sleep

In 2011, the S&P 500 Index experienced twice the average volatility of the last 50 years. And by our measure the Dow Jones rose and fell a total 56,735 points in 2011 just to finish up about 640 points. That much traveling certainly creates what we call “[volatility fatigue](#).” Overseas, every major index except Indonesia and Philippines saw losses: Italy -25%, India -24%, China -20%. Even the UK, Germany and Canada, relatively “strong” economies, experienced losses of -5%, -14% and -11%. These poor showings cast doubt on whether the U.S.'s relative strength (the S&P 500 essentially returned 0%) over the past 12 months is legitimate.

In terms of an outlook, we won't be surprised if 2012 looks much like 2011. Although we're starting the year with a “cheaper” market and stronger economy than last year, we think above normal volatility and below normal returns are the most likely scenario. Therefore, our response and strategy continues to be founded on creating a “floor” by



having a portion of our expected return come in the form of dividends and interest; cash earnings that can't be taken away. Yet this is not at the expense of potential capital appreciation. For instance, our top twenty US Stock holdings sell for an average 86% of Fair Value (a 14% discount) while producing an annual forward dividend yield of 3.48% (Note: as seen in the [chart](#), the 1600+ US Stocks we actively monitor

are selling for around 90% of fair value, a 10% discount, and earn just 2.10% dividend yield). In addition, our expected returns come from companies that tend to be in the best positions in their sectors (they have the most cash on their balance sheets, the widest economic moats, strong dividend pedigrees, etc.). In other words, we don't lose sleep waiting for those companies to reach their fair values. We're being paid to wait.

While the capital markets are both unknowable and uncontrollable, the cash flowing into and out of our readers' homes are far easier to know and control. We're doing just that by helping our clients review budgets, analyze debt refinances, update retirement plans, and even maximize charitable donations. By now the majority of New Year's resolutions have been broken, we encourage you to make one now, and we'd be honored to be a part of it.

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