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LEARN HOW THE PROS REDUCE MARKET RISK

Leigh Baldwin & Co. Investment Brokerage Newsletter

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The Legs Feed the Wolf

In the film, "Miracle on Ice", Kurt Russell was impeccable as he portrayed legendary hockey coach, Herb Brooks. The late coach enjoyed an amazing coaching career, winning three collegiate national championships and then the Olympic Gold Medal in 1980. Following an extended NHL career, Mr. Brooks passed away after a car accident in 2003. One of the most memorable lines from the movie occurred after an arduous practice. The coach commented, "The legs feed the wolf, gentleman; the legs feed the wolf!" The analogy is clear. Through training and conditioning, the animal, or in this case, the player, can outlast an opponent and ultimately gain the prize.

If Herb Brooks were the coach of your investment portfolio, he might say "The earnings feed the stocks, investors; the earnings feed the stocks!" And instead of requiring you to do sprints on the ice, he would demand that you read the annual reports again and again and again! Ultimately, any investment, stocks, bonds, and/or mutual funds, are driven by the current and prospective profit of the company. For example, when you invest in a stock, think of it as if you owned 100% of the company. Then you would determine if the profits and cash flow befit the price of owning that company. Examine the earnings and revenues over the last several years, and determine if they have risen smoothly and steadily during that time. A good business then becomes, by definition, a company that generates more cash than it consumes, and puts that cash to either good use for growth within the company or disperses it to owners (shareholders) in the form of dividends. The key to investing like a champion is to invest in companies that have an ability to sustain consistent earnings growth.

Stocks of Interest

Unitedhealth Group (UNH): This stock exemplifies the old adage: "if you can't beat them, join them." Not a day goes by without someone complaining about the high cost of health insurance, and UNH is one of the premier providers of healthcare services. In fact, 2006 revenues of this $50-billion dollar company could qualify it for placement in the Fortune 20. The fifteen-year compounded rate of return on earnings has been an impressive 32%. Here is the catalyst, with an SEC probe into their compensation of executives, most notably CEO Dr. William McGuire, the stock has fallen 31% during the first part of 2006. We look for UNH to bounce on the strength of its long-term earnings potential.

eBay (EBAY): eBay is the world's largest e-commerce marketplace and has enjoyed dramatic success since its inception in 1995. Last year, for the first time, earnings exceeded one billion dollars and operating cash flow exceeded two billion dollars . With pressure on the stock, eBay is currently trading at just 50% of its all-time high price of sixty dollars per share. The purchase of Skype in 2005 provides a launching pad for their communications business. Impressively, Skype added 190,000 users on average per day, bringing the total to 75 million users. Few companies can match the earnings power that they have achieved in just over ten years.

General Electric (GE): As the last of the original Dow 30 stocks, GE has recreated itself into somewhat of a "green company." It has made significant investments into water, wind-power, and several other alternative energy investments. GE reported a record first quarter this year, earning four billion dollars, a 14% increase in continuing operations, and a record of 37.8 billion dollars in revenue from continuing operations. GE is an earnings story that has caught the attention of investor Warren Buffet.

Mutual Funds of Interest

LEH preferred G (LEH-G): Although not technically a mutual fund, this preferred stock is based on the short term interest rates measured by the LIBOR rate. As short-term interest rates rise, so will the yield on this stock as they pay .75 % above the LIBOR rate. The current yield is about 6%.

Oppenheimer International Diversified Fund (OIDAX): OIDAX is a "fund of funds," whereby they have access to a wide variety of international investment opportunities via five different mutual funds. Three of the five international funds have achieved at a four star rating or better from Morningstar, and the diversification of this fund is unique. The question is not whether you should invest internationally, but rather how much should you invest internationally.

Diamond Hill Long-Short Fund (DHFCX): DHFCX is a five-star rated fund that provides exposure to both the ups and downs of the stock market. The managers typically invest in thirty or more stocks that they favor for appreciation while simultaneously shorting about 40% of the portfolio in stocks that they dislike. DHFCX is a hedge fund in traditional mutual fund clothing that has had recent outstanding success. ■

Investment Strategies

Stock Market Volatility

Time-tested strategies used by the pros to reduce market risk

Understanding Investment Risk

Managing investment risk does not mean avoiding it because all investments have some degree of risk. Nor does it mean minimizing risk since investments with the least amount of risk usually offer the lowest returns. Therefore, they may not meet your long-term objectives.

Undue conservatism can be as damaging to a long-term investment program as excessive risk taking. One of the most important goals for long-term investors is to manage an appropriate balance between risk-return trade offs.

The first step toward effective risk management is understanding. Risk is a muti-faceted term. Most people focus on principal risk, which is the possibility of a loss in the value of your investment due to a drop in price. While **principal risk** occurs for a variety of reasons, it is most commonly caused by market risk, credit risk, interest rate risk, or currency risk.

Another general form of risk is **income risk**, which is the possibility of a reduction in the amount of current income that your investment earns. This is typically caused by declining interest rates. Not so long ago, when interest rates were in double digits, investors often deemed income risk less important than principal risk. But today, with interest rates at their lowest level in 25 years, income risk has affected millions of investors.

Inflation risk is a third general type of risk, and it can affect both principal and income equally. If your investments do not increase in value, inflation can erode the purchasing power of both your principal and income. That is why it is vitally important for long-term investors to focus on growth strategies to help reach their financial goals.

Wise investing stems from matching your own temperament and needs to your investment goals. The range of investment possibilities is enormous, from guaranteed Government Bond issues to the high-flying realm of options and commodities. In between, there are stocks and bonds.

Investors should understand that calculated risks taken in a conservative manner over the long term will provide consistent positive returns. Consider your own temperament as well as how much money you can afford to lose before you invest at all.

Investing can at times seem overwhelming, but it can be simplified into 4 key concepts. The following represents the major components of a successful equity strategy including a working check list.

Diversify your investments

At the heart of modern portfolio theory is the concept of diversification. To properly diversify means to buy different types of investments so that you are not over-exposed to any one type of risk. In other words, don't put all of your eggs into one basket. As it relates to stocks, diversification is achieved by owning shares in a number of companies whose prices do not move up and down for all of the same reasons. A properly diversified portfolio will lessen the stock market peaks and valleys.

Number of stocks

A vital consideration in constructing a well-diversified portfolio of equities is the number of stocks to include. The basic principle is that as the number of stocks increases, risk is reduced. How many stocks should you own? A typical standard is to limit exposure per stock to no more than 15% of your portfolio. As an example, if you have $60,000 to invest, a suggestion would be to purchase at least 6 different stocks.

Stay diversified among industry sectors and investment styles

How you diversify also has a dramatic effect on your return. The ideal way to reduce risk is to combine investments that are sensitive to many different conditions. Consider owning non-cyclical consumer stocks (such as beverage, food, drug, or household products), which are generally impacted very little by changes in the economic cycle. In addition, consider cyclical companies (such as technology, oil, automotive, steel or retail). These are referred to as industry or sector groups. In order to minimize per-

Investment Strategies

Stock Market Volatility *continued from page 3.*

formance volatility, try maintaining diversification among various industry groups.

Investment style
Try to use a blend of investment styles. The two most commonly used investment styles are growth and value. Growth investing focuses on companies that are displaying rapid and consistent revenue and earnings growth. Value investing emphasizes the underlying value of a company's assets and is more likely to include stocks that are out-of-favor with investors. By using a balance of growth and value investing, investors will reduce performance volatility in the short term.

International investing
Foreign equities offer investors the opportunity to gain exposure to non-U.S. economies and markets. The inclusion of overseas investments will reduce the overall risk in a portfolio since foreign markets and economies are influenced by different factors than the U.S. market. Owning an international mutual fund is a conservative strategy for gaining foreign exposure. Many countries have changed from state-run, managed economies to more capitalistic, market-based economies. During the transition periods, there are usually large demands by consumers for goods and services.

Develop a strong buy and sell discipline

Dollar cost averaging—buy high, buy low, sit pretty!
Rather than trying to time market highs and lows, investors should adhere to a strategy known as dollar-cost averaging—making equal-sized investments on a regular basis without regard to market timing. The advantage is that you buy more shares when the price is lower and fewer shares when the price is higher.

You do not have to be a Wall Street guru to benefit from dollar-cost averaging. In fact, if you are making automatic deposits from your checking account into a mutual fund or re-investing stock dividends, you are already dollar-cost averaging.

Dollar-cost averaging prevents you from being emotionally whipsawed by the market. It is human nature to be frightened away from owning stocks or bonds when prices head down even though experience has shown that such times can be the most opportune. On the other hand, investors often buy when prices have already risen dramatically. This can be foolish. Dollar-cost averaging brings a discipline to investing because it ensures that you invest in different market environments. *(It must be emphasized that this is a strategy which neither assures a profit nor protects against a loss in a declining market.)*

Rebalance your portfolio periodically to maintain an appropriate asset mix.
The best way to explain this strategy is with an example. Suppose that an investor, whose primary objectives are long-term growth with a little income, determines that an asset mix of 70% stocks and 30% fixed-income is appropriate. When the asset mix varies from the pre-established target, the portfolio should be readjusted. For instance, with the tremendous rise in the stock market over the last 7 years, your asset mix might have expanded to 90% stocks and 10% bonds. Since the current asset mix no longer complies with your pre-established target, your portfolio should be adjusted accordingly. This discipline correctly forces the investor to sell into a rising market and buy into a falling market.

Rebalance your stock holdings to maintain an appropriate level of diversification.
By maintaining diversification, you will reduce risk as well as establish a strong buy/sell strategy. For example, rebalancing stock holdings will force the investor to reduce exposure to industries and individual positions that have become overweighted because of strong performance.

Buy stocks with consistent earnings

It is vital for you to own companies that will perform well over the long term. A record of consistent earnings over a long period of time gives you the confidence to hold the stock during turbulent market fluctuations. When conditions reverse, you will be reasonably assured that your stock will again prosper. Look for companies with successful management and well-defined business strategies.

Have realistic long-term expectations

Although the long-term trend for stocks is upward, there are many peaks and valleys along the way. The long-term investor should be prepared for the declines that will occur. Rather than trying to predict the market's next correction, try to develop a philosophy that recognizes that these declines are buying opportunities.

Investors should focus not on market direction, but on disciplined, periodic accumulation of quality growth stocks at depressed prices, undervalued secondary or special situation stocks, and/or quality stocks on a dollar-cost averaging basis.

To maximize your return, consider an investment horizon of at least five years for any portfolio containing equity securities. For any portfolio with less than a five-year holding period, the portfolio should probably consist predominantly of fixed-income investments. This five-year investment period is critical. The investment process must be viewed as a long-term plan for achieving the desired results. ■

"Breakfast on Wall Street"

Listen to Leigh Baldwin and Ken Iselmoe each week as they host "Breakfast on Wall Street" each Sunday morning at 8:00 a.m. on WKXZ 93.9 FM or at 10:00 a.m. on WHEN 620 AM. They will take a look at the week on Wall Street in their own inimitable style.

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