

# FOCUS

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***Inversion =  
recession?  
Not necessarily***

Much has been made in the press of late about the fact that the yield curve has inverted. In other words, short-term interest rates have moved slightly above longer-term rates. The hoopla has erupted because there is a belief (myth?) that inversions lead inevitably to recessions.

In fact, many inversions in the past—but not all—have been followed by recessions. However, a key element in those that have preceded economic downturns has been the level of real short-term rates, i.e., the difference between the current Federal Funds rate and the core rate of inflation. In the most serious of the recessions in recent history, real rates have been at 4% or higher. When real rates have been lower, inversions have not led to recessions.

With real rates today hovering near 2%, there appears to be little reason to expect that we will be in a recession any time soon.

***Growth  
investing  
debunked***

A very interesting study published recently by AllianceBernstein goes a long way towards explaining why so many growth investors and mutual funds underperform their value-oriented counterparts. In a nutshell, it has to do with earnings expectations that are too high and which, when unmet, lead to disappointments and rapid, downward price adjustments.

The core of the argument is that due to competition, expiry of patents, growing too large and losing flexibility, or a variety of other reasons, over time “great companies become good, and good companies tend towards mediocrity.” In other words, their performance reverts to the mean, or sometimes less than the mean.

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To document these findings, the study looked at year-over-year earnings growth rates for a sample of over 600 companies over the 25-year period from 1980 through 2004. On average, only about 9% of those companies could grow their earnings more than 10% a year for three consecutive years. Another 11% maintained positive growth for three years but slipped below 10% at least one of the years. Thus, about 80% of companies posted negative earnings growth in at least one year of the three year periods analyzed. As the study concludes, “Given these results, it should not be surprising that the majority of high consensus growth-rate estimates tend to meet with disappointment, and that the investment returns of high-growth companies as a group are therefore subpar.”

This does not mean that a few companies can't in fact grow at 10% or more for more than three consecutive years. It also does not mean that a company can't have multiple periods of above-par growth, albeit interrupted by one or more sub-par years. However, the longer that growth continues, the higher the probability that at some point it will stall, leading to the inevitable earnings disappointment and attendant price correction. For this reason, we regularly recommend to clients who have large positions in or work at high-growth companies that they institute a plan for periodic pruning of their holdings. Yes, they may leave some money on the table. However, in the long run, our thirty-plus years of experience with clients at a variety of “growth” firms has shown us that they are likely to be better off being realistic instead of greedy.

***A cliché a day***

The December 27, 2005 issue of *The Wall Street Journal* ran an article entitled “A cliché a Day Keeps Wall Street Losses Away.” If it were only that simple. The article did explain many of the sayings that one hears in our business and that you may see in the financial press, so we thought that we

would begin the New Year by bringing some of them to you, paraphrased from the *Journal*, just in case you missed it.

*The Santa Claus Rally.* The WSJ points out that stocks often rally after Christmas, and the fourth quarter is, on average, the year's strongest. The Dow Industrials have suffered a fourth quarter decline just once in the past ten years and that was in 1997, according to the *Journal*. The rally has to do with strong corporate profits in the fourth quarter and anticipation of big injections of retirement money into stocks in the coming New Year.

*Sell in May and Go Away.* Historically speaking, the market's biggest gains have occurred during the months October through April. Usually, the market rises little from May through September. In most years, the winter is better for stocks.

*Summer Rally.* Even though this is referred to often, there isn't much to it according to the *Journal*. Every season seems to have at least one rally during it, but the summer tends to be a weak period and usually ends with a thud.

*Beware the Dead Cat Bounce.* This can apply to a single stock, or the entire market, which has crashed and then bounces back up momentarily. Investors can be fooled into thinking that the bounce is the beginning of a new rally. The analogy is that of a cat falling from a very high perch which kills it on landing, yet the cat bounces up briefly as a result of its momentum and the unyielding pavement.

*Buy the Rumor, Sell the News.* Stocks often rise on the rumor of good news to come, like anticipated good earnings reports. Then, when the news is actually announced, short term traders often sell to take their profits. Of course, this can work in reverse too. Sell the stock on a rumor of bad news and buy it back when the news is announced. The underlying concept here is that the actual news is usually not as good or as bad as it is rumored to be, hence creating the opportunity.

*Don't Catch a Falling Knife.* This means avoid buying a falling stock, because sometimes when things look bad, they actually are bad, and there is much more room to fall. Better to wait for the fall and the dead cat bounce to be over.

*Stocks Climb a Wall of Worry.* Bull markets begin after investors have taken money out of the market and have it free to invest. As they resolve, one by one, the fears that caused them to take their money out in the first place, they put their money back in and the market rises. They are still worried and hence are climbing the wall of worry. When their worries vanish and they become optimistic, the market usually tops out. The moral here is to buy when the market is pessimistic and sell when it is optimistic.

*Don't Fight the Tape.* The market used to be tracked by ticker-tape machines, and this saying has mostly to do with market psychology. Basically, if the market is moving strongly in one direction or the other, it may not be a great time to bet against it, no matter how smart you are or how good your analysis. A positive way to say the same thing is, "the trend is your friend."

*Don't Fight the Fed.* This simply means to be aware of what the Fed (Federal Reserve) is doing with the money supply and interest rates and don't bet against those actions. If the Fed is restricting the money supply, that should put a crimp on the economy's growth. Same result if the Fed is raising rates. The stock market tends to react negatively to these actions by the Fed.

*It's Not a Stock Market, It's a Market of Stocks.* When the market is dull and going nowhere, one cannot make money buying the overall market by investing, for example, in a market index fund. At times like this, one can only make money by buying specific stocks that outperform the market. Also heard in the same breath is, "This is a stock picker's market."

This past year was a dull but nevertheless positive one for the U.S. stock market. Investors were held back by legitimate fears: hurricanes, wars, rising interest rates, rising oil and gas prices, potentially high inflation, trade deficits and domestic budget deficits. We expect 2006 to be good year for the U.S. stock market as investors put aside their fears, one at a time, and “climb the wall of worry.”

**Technology  
corner**

We’ve come across two programs that we have found extremely useful which may be useful to you as well. The first is *GoToMyPC*, offered by Citrix. This program allows you to access an enabled computer over a secure link from anywhere in the world using just a web browser. Your editor has used it to log into his office computer from as far away as Greece. You can even generate a list of one-time use passwords to prevent malicious spyware on public computers from gaining access. Of course, the target computer has to be on for you to access it.

The other program is *FolderShare*. This software does two things. First, allows you to share files (photos, documents, whatever) with anyone anywhere, again over a secure link. For us, the more interesting feature is the ability to maintain synchronized files on two (or more) computers. For example, your editor keeps his personal email files on his home machine and his office machine synchronized, so that both machines always have the most recent emails, even if one has been off for awhile.

**As a reminder**

For the benefit of newer readers, and as a refresher for those of longer standing, we publish every other year or so a review of the services we offer and the type of clients we serve. In a nutshell, we manage broadly-diversified portfolios on a fee-only basis for wealthy individuals and family groups and small- to medium-sized institutional accounts such as foundations and retirement plans. For individuals

and families, we can also provide comprehensive financial planning services, both before we begin active portfolio management and thereafter on an ongoing, as-needed basis.

Our minimum account size is currently two million dollars. There are two important caveats to this statement, however. First, our long-term goal is an average account size of over two million dollars so that we can focus our attention on a relatively small number of accounts. For this purpose, an account may be either an individual or an entire family group. Second, we are far more interested in developing successful, long-term relationships than in maximizing current revenues. Therefore, we are always open to serving almost any client if there is a high likelihood that there will be significant additions to the account over time, whether from asset sales, inheritance, savings or other sources.

We have several pieces of descriptive material that address the subject of our services and investment philosophy at significantly greater length. This material is also available on our website, [www.woodsideasset.com](http://www.woodsideasset.com). If you would like to receive this information, please either contact us or visit our website. And, if you know one or more individuals or organizations who fit our client profile and who may benefit from our services, we would greatly appreciate an introduction and welcome the opportunity to meet with them.

### ***Golf truths***

Golf can best be defined as an endless series of tragedies obscured by the occasional miracle, followed by a good bottle of beer

If you find you do not mind playing golf in the rain, the snow, even during a hurricane, here's a valuable tip: your life is in trouble.

The term "mulligan" is really a contraction of the phrase "maul it again."

A “gimme” can best be defined as an agreement between two golfers, neither of whom can putt very well.

An interesting thing about golf is that no matter how badly you play, it is always possible to get worse.

Golf is the only sport where the most feared opponent is you.

Golf is like marriage. If you take yourself too seriously it won't work, and both are expensive.

The best wood in most amateurs' bags is the pencil.

To some golfers, the greatest handicap is the ability to add correctly.

In golf, some people tend to get confused with all the numbers—they shoot a six, yell fore and write five.

If you find yourself pleased that you locate more balls in the rough than you actually have lost, your focus is totally wrong and your personality might not be right for golf.


***Inside Woodside***

Both Bob and Morgan were interviewed last year for magazine articles. Bob's interview with *The Wall Street Transcript*, in which he discusses our strategy of global asset allocation, and Morgan's interview with *Research* magazine, are posted on our website.

***And last but not least...***

...A happy, healthy and prosperous 2006 to all! 🍷

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