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Investments: Long Term Buy and Hold or Day Trade?

What's the best way to invest your money? In my parent's day, conventional wisdom was that the best investment strategies for accumulating wealth were built on safety and security. This usually translated into a belief in "the American Dream" – home ownership – and "squirreling" away money into FDIC-insured passbook accounts, CDs, T-bills and other more secure instruments. Little did they know that I'd enjoy making finance my career.

Fast forward to today.

Since the beginning of this decade, real estate has garnered the attention of both professional and amateur investors alike. What used to be the ultimate long-term buy and hold investment, seems to now have turned into a trader's game. Haven't you heard about the latest craze – flipping condo contracts in "hot" markets like the Baltimore suburbs and South Florida? No wonder Mr. Greenspan is concerned about real estate bubbles!

But this month's letter is not about investing in real estate.

Last month, together with some of my office cohorts, I went to the Money Show in Washington, DC. Held over several days, the Money Show was a personal finance and investment education conference for [predominantly] individual investors that featured in-depth education and advice across a broad spectrum. It was reported that the attendance exceeded several thousand. It certainly seemed like it!

At the show, it was interesting to see that a number of workshops and vendor exhibits featured trading strategies – mostly day trading! What's more, I observed that many of the day trading workshops were well attended by handsomely groomed folks whom, the majority of, looked like they were at or nearing retirement age!

Wikipedia.com, the free internet encyclopedia, defines day trading as the practice of either buying and then selling or selling then buying a stock within the same day. On the other end of the spectrum, the long term buy and hold practice (also known as the "buy and forget" strategy), suggests that investors rely on the belief that in the long run the investment will be profitable. In certain situations, both strategies work. But not always and not for everyone!

As readers of my newsletters well know, wealth management is the ultimate goal of all that we do at Hoffman, White and Kaelber. Yes, we promote our services; yet, you will find that we always seek to present thought provoking topics that are relevant to our wide audience.

In this edition, we'll take a look at understanding each of these investing practices – when they might work and when they might not. Lastly, we will finish with a review of the economic and investing climate for the month past, the current market outlook and our investment performance.

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Trading and Investing Are Very Different

Every investor is affected by some degree to trading and the cost of transacting. This refers to trading as a function rather than one's investment strategy. While it is important, if not very helpful, for investors to understand the rules and operational aspects of executing a securities trade, to make it one's occupation or base one's wealth generating strategy on active trading is another thing entirely!

The mindset of an investor is quite different from that of a trader. An investor generally seeks to know plenty of fundamental information about his or her investment. On the other hand, the trader uses other information in seeking quick short-term profits with the hope of earning potentially greater gains. This should be puzzling to some, since the traditional concept of stock ownership is that it's shared ownership in the prospects of a company. Yet the trader has little use for the concept of ownership. Rather, he or she is more interested in the short term dynamics of supply and demand and how to quickly turn a profit.

Sound investing requires thorough fundamental analysis of a security to determine if it is attractive or not. For example, to increase the probability of making a good stock investment, an individual should try to buy that stock at a good price. In order to do that, the investor needs to determine if the current price of the investment is attractive relative to others by studying earnings trends, current and future business environments, interest rates, and many, many other factors. In making the investment, the investor is not concerned with what is going to happen to the price of the stock the next day, because investments are longer term in nature.

Trading is not investing; trading is more speculative. A trader is not trying to predict what is going to happen in the next 10 years. He or she is concerned with price fluctuations immediately after initiating a position. His or her goal is "turn a profit" as soon as possible after the opening trade. The term "opening trade" refers to executing a "buy" (to go long) or "sell" (to go short) transaction after which the person has is at-risk in the market place; a "closing trade" would be the corresponding "sell" or "buy" to end being at-risk on a position. In order increase his or her chances of trading successfully, a trader may study past and current price and volume history to determine what might happen next.

A day-trader trades within the time frame of one day, entering and exiting positions within the day but always closing out trades by the end of the day, win, lose or draw. To be successful, a day-trader must have the discipline of a machine, the instincts of a fox, the emotions of a rock, the skills of a surgeon and the patience of a saint. A little luck wouldn't hurt either.

Large short-term profits can often entice those who are new to the market. But adopting a long-term horizon and dismissing the "get in, get out, make a killing" mentality is a must for any investor. This doesn't mean that it's impossible to make money by actively trading in the short term. But, as we already mentioned, investing and trading are very different ways of making gains from the market. Trading involves very different risks that buy-and-hold investors don't experience. As such, active trading requires certain specialized skills.

Neither investing style is necessarily better than the other - both have their pros and cons. But active trading can be wrong for someone without the appropriate time, financial resources, education and desire. And, most people just don't fit into this category.

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What an Aspiring Day Trader Should Consider

Day-trading, once the exclusive domain of floor traders and of the larger investment firm's proprietary trading desks, is now fair game for all speculators. Inspired in part by instant availability of quotes, affordable high-powered computers and competitive on-line commissions, the new wave of day-trading methods and systems has attracted thousands of traders in recent years. The undeniable thrill of trading is, however, a double-edged sword: one that can hurt as well as heal.

Trading successfully is by no means a simple matter. It requires time, market knowledge and market understanding and a large amount of self restraint. Anyone who says you can consistently make money on every trade is not being truthful. Don't expect to generate returns on every trade. Following that, in order to increase your chances of making a successful trade, a trader has to take into account technical and fundamental data and make an informed decision based on his perception of market sentiment and market expectation.

The people at ACM, SA, a subsidiary of REFCO Group Ltd., suggest what a trader needs to do in order to put the best chances for profitable trades on his or her side.

Trade with money you can afford to lose. Trading is speculative and can result in loss, it is also exciting, exhilarating and can be addictive. The more you are 'involved with your money' the harder it is to make a clear-headed decision.

Identify what the market is doing. Is it trending upwards, downwards, or in a trading range? Is the trend strong or weak, did it begin long ago or does it look like a new trend that's forming? Getting a clear picture of the market is important when preparing to trade.

Time your trade. You can be right about a potential market movement but be too early or too late when you enter the trade. Timing considerations are two-fold. Timing your move means knowing what's expected and taking into account all considerations before trading.

If in doubt, stay out. If you're unsure about a trade and find you're hesitating, stay on the sidelines.

Trade logical transaction sizes. In short, don't trade amounts that can potentially wipe you out and don't put all your eggs in one basket.

What is the market's expectation? If people are expecting an interest rate to rise and it does, then there usually will not be much of a movement because the information will already have been 'discounted' by the market. Alternatively, if the adverse happens, markets will usually react violently.

Use what other traders use. The great diversity of opinions and techniques used translates directly into price diversity. Traders however have a tendency to use a limited variety of technical tools. The closer you get to what most traders are looking at, the more precise your estimations will be. The reason for this is simple arithmetic, larger numbers of buyers than sellers at a certain price will move the market up from that price and vice-versa.

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If you're going to try your hand at day trading, understand that the odds are high that most newcomers typically suffer severe financial losses in their first months of trading, and many never graduate to profit-making status. The US Securities and Exchange Commission warns: "While day trading is neither illegal nor is it unethical, it can be highly risky. Most individual investors do not have the wealth, the time, or the temperament to make money and to sustain the devastating losses that day trading can bring."

Although day trading has become somewhat of a controversial phenomenon, its prevalence is undeniable. Day traders, both institutional and individual, play an important role in the marketplace by keeping the markets efficient and liquid. Some argue that individuals should stay away from day trading, while others argue that it is a viable means to profit. And although it is becoming increasingly popular among inexperienced traders, it should be left primarily to those with the time, skills and resources needed to succeed.

The antithesis of day trading is the "buy and hold" strategy. Buy and hold is a long term investment strategy based on the concept that, in the long run, equity markets give a good rate of return despite periods of volatility or decline. This viewpoint also holds that market timing, the prospect that one can enter the market on the lows and sell on the highs, does not work or does not work for small investors so it is better to simply buy and hold.

Just as day trading may not work for everybody, "buy and hold" has its problems also.

What an Aspiring Buy and Hold Investor Should Consider

The buy-and-hold is said to be the most commonly used investment strategy among individual investors. Many choose this method because of its simplicity – buying a stock and holding onto it, no matter how much the price rises or falls. Buy-and-hold investors usually sell their stocks only when they have reached a certain goal such as making enough money for retirement, a college fund, or a house. Investors can buy a stock, hold onto it, and not have to worry about the right time to sell. Two additional benefits to the buy and hold strategy are that trading commissions can be reduced and taxes can be reduced or deferred by buying and selling less and holding longer.

The "buy and hold" approach to investing in stocks rests upon the assumption that in the long term (over the course of, say, 10 or more years) stock prices will go up, but the average investor doesn't know what will happen tomorrow. Historical data from the past 40 years supports this claim. The logic behind the idea is that in a capitalist society the economy will keep expanding, so profits will keep growing and both stock prices and stock dividends will increase as a result. There may be short term fluctuations, due to business cycles or rising inflation, but in the long term these will be smoothed out and the market as a whole will rise.

Market timing is an alternative to buying and holding. Market timers believe that it is possible to predict when the market, or certain stocks, will rise and fall. Does it therefore make sense to buy when the markets are low and to sell when they are high in order to maximize profits?

Investing is a process of making decisions today to achieve results that will not be known until tomorrow. Because nobody can control everything that is going to happen tomorrow,

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nobody knows what tomorrow will bring. As such, most experts agree that market timing is incredibly difficult if not downright impossible. They also warn against it because:

- It's hard to say when the market or a particular stock is "high" or "low".
- Commissions and or bid/ask spreads eat away at your profits when you trade frequently, especially on small transactions.
- In the last 40 years, the market returned about 11.3% annually. If you were fully invested the whole time, but got out completely for the 40 best months, your annual return would've dropped to 2.7%. If you miss the big moves, it hurts, and no one really knows when they're coming.

But, buy and hold doesn't work for most people because most people, for one reason or another can't seem to stay in the game! Here are some reasons why:

- The market can easily move sideways or down for periods of 10 years – buy-and-holders can lose money for 10 years! Think of a retired household whose living expenses are paid from savings. Do you think this might impact one's life style?
- Bear markets may seem insignificant when you have only \$10,000 invested, but what about a hard earned portfolio of \$500,000. Every time the market falls 5% you've lost \$25,000. Now, imagine the market correcting by 30% over several months - you've now lost \$150,000. The pressure to sell out and save your remaining \$140,000 will be very difficult to resist.
- Most people give up and sell out very near the bottom. That's what emotions will do for you. It's very easy to say you'll ride out a bear market while the market is soaring, but almost impossible when the market is crashing and all you hear from the media is how the market is going down to zero.

This is the problem with Buy and Hold. It's easy to stick with when the market is rising but impossible when the market is falling. If you think you're different and can ride out a bear market you'd better think again about how emotionally painful it will really be.

Despite battling the odds of uncertainty, most money managers are practicing some form of market timing. But the truth is that most timers are trying to flatten out the risk and volatility in a portfolio, and are willing to trade some returns for stability.

Concluding Thoughts

A trader must have the discipline to pull the trigger without wavering – whether it means cutting a loss, snapping up a profit, or entering a new trade after the last three trades have dealt losses. An investor must often do just the opposite – he or she must avoid pulling the trigger just because a position is presently showing a loss or a quick windfall profit.

Some individuals easily adopt one strategy or the other because it simply works best for their own personality and emotional make up. As a result, there are people who are totally immersed in the market day-to-day on an ongoing basis. On the far end of the spectrum, there are people who put money into mutual funds – often ones they don't understand – and never sell them. They just keep putting money in until they either retire or otherwise need the money. And of course, there is everything in between.

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If you listen to the people at one end of the spectrum or the other, they will often tell you that theirs is “the best” way. What you must do to succeed at investing may be completely different. The key is to determine where you fit in.

Hoffman, White & Kaelber Financial Services Investment Performance Update

One year ago, crude oil prices were approximately \$30 a barrel, well below the \$65 to \$70 mark that they are now. US average gasoline prices were below \$2 a gallon; now they've exceeded \$3. Natural gas prices are better than twice where they were 12 months ago. As well, last September, the expectation was that energy prices were peaking and that they would slowly erode through much of 2005 and 2006. Wow! What a difference a year makes!

Hurricane Katrina, continuing problems in the Middle East, heavy energy purchases by India and China, and refinery shortfalls seems to have forced most energy analysts to rethink their recommendations. The current belief is that high energy prices are likely here to stay, and if they do start to decline, they might only fall moderately over the next year or two.

With higher prices for gasoline and heating fuels, will consumers still remain the backbone of our growing economy? That's remains a big question. Tax cuts and strong housing prices supported purchases of consumer goods such as appliances and other furnishings. But, current spending rates relative to household income seems unsustainable – the latest government reports suggest that consumers are prematurely spending down their savings. How long can we depend on personal consumption? Will business spending pick up? Only time will tell.

For the month ended August 31, 2005, our one-month performance is down 0.01%, our year-to-date return is up 2.75%, and our average annualized return since inception is up 8.40%. While volatility has become exceedingly vigorous in the equity markets, our risk profile continues further downward to +/- 5.67%. This conservatively low risk level remains consistent with our strategy. With our expectation that this statistic gains increasing importance, our Sharpe Ratio is more than respectable at 1.18.

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