Capital Drain

Rick's investment opinion newsletter April, 2006 v.2 no.3

Hi Readers,

In my opinion:

Executive Summary:

This is a first. I really don't have anything to say.
Why? Because everything is just like last month, only more so.

The usual:

As before, I think everyone is best off with a **broad diversification** that includes at least **3/4 overseas** assets (easily purchased via US mutual funds), reflecting the distribution of world economic activity.

These are **not the best of times**, so investors need to be in the best of securities: stick to value, to safety, to short maturities (for debt), and call me to chat if you're concerned about anything you're holding.

Above all, avoid the investments that are at all-time extreme valuations: junk bonds, developing-country bonds, and headline-grabbing stocks such as Google, Whole Foods, or Taser.

Sure, Google is doing great. So was Pets.com once upon a time. Google's a pretty good company, but at the current price you could only buy based on the Greater Fool Theory: "Sure, I paid too much, but I'll find a Greater Fool to whom I can sell it for even more!"

The Details:

> I keep six honest serving men
> (They taught me all I knew);
> Their names are What and Why and
> When; And How and Where and Who.
>
> **Rudyard Kipling**

(Of these, my favorite remains "Why.")

What I said last month is still true, only more so. You can re-read the previous letter on the web here: http://www.ricks-cafe.net/CapDrain/CapDrain_v2n2.pdf

If you took any of my advice last month, you're probably pretty happy now.

- The dollar continues to fall, which means your foreign stocks and bonds (purchased through US mutual funds) continue to rise.
- US interest rates continue to rise, so medium-to-long US bond total returns are bad. If your "bond" money is in very short maturities, such as money market funds, then you are getting decent interest and not suffering any (more than) offsetting capital losses.

I think both of those trends will continue, probably for quite a while.

Also, gold is still rising like a rocket, which has prompted friends to ask me if it's not already too late to buy in and enjoy a continued rise. I have NO idea.

Honestly.

The recent big jumps in the price of gold are way more than anything I would have rationally predicted. Now, it could stay hyper-enthusiastic, or it could revert to a more rational trend line (meaning fall in the short term before resuming a slower rise), or it could just dither and fiddle. I have no clue.

What I do know is that if you bought gold a year ago February, you're holding about an 85% gain. That gives a person a buffer to be philosophical on the days that it drops three or four percent. If you'd just bought the day before, that would be pretty scary.

I can say with confidence that I would be chicken to buy gold now. I would not do it. At the same time, I'm philosophically not selling as long as the trend seems to be up.

Incidentally, that's a good example of another **Behavioral Finance** finding, called mental accounting. A dollar is a dollar. Mathematically and rationally it doesn't really matter if it's the dollar you invested yesterday or a dollar of unrealized capital gains.

We humans are only sporadically mathematical and rational, so we do what I just did: think of the dollar of gains as if it were in a different "account" from the dollar invested last payday.

In this case, I don't think this little irrationality is a significant problem. It helps me feel calm about continuing in a fairly volatile investment. Taken to extremes, though, some people are particularly reckless betting their gains, far beyond how they would behave with "their" money.

In Las Vegas, they call this syndrome "gambling with house money," and the increased recklessness with winnings (the casino's or "house's" money) is part of the reason that money that goes to Las Vegas stays in Las Vegas. Any early winnings are routinely lost well before the flight home departs.

Try not to do this to extremes with your investments, OK?

And that's all I can think of to say.

If you have any questions, please please write or phone. If you want to read more, I've got a web site with old editions of this letter and some links to other interesting sites.

Please feel free to forward this to any friends who may be interested.

Take care,

Rick

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"Our doubts are traitors,
And make us lose the good that we oft might win,
By fearing to attempt."
--W. Shakespeare
