Reasons not to invest with me

Don't get me wrong. I want investors, but I want well-informed investors. Every investment strategy has cold streaks, and I would like to be judged over a full market cycle rather than over one month's or one year's results. I would like my client assets to be sticky, unless I do something truly horrible. Here are reasons not to invest with me:

1) I'm just one person. I am healthy, but I could be hit by a bus tomorrow, and then how would the assets be managed? Also, the challenges of managing a business by myself and growing it could prove deleterious to my ability to manage the assets well. I think I am up to the challenge, but you never can tell.

Now, I don't trade that frequently, and I tend to hold high quality companies, so if you hear that I have died, you probably won't be badly affected; just take control of your account, and liquidate my positions, and replace them with a S&P 500 ETF, or cash, as you see best.

2) I don't trade very often. In general I hold stocks on average for three years. Some months I do not trade much at all; some months I trade a lot. When the market is in a trading range, I tend not to trade that much. After the market has been in a sustained rally, I tend to sell. After the market has been falling significantly, I tend to buy. Please don't equate level of activity in your account, or the lack of it, as a sign that your assets are being improperly managed.

I do trades for two reasons. Reason number one is 3 to 4 times per year, I make changes to the portfolio. I typically buy three or four new stocks at each point in time and sell an equivalent number. The reason I don't do this on continuous basis, is that by making fewer decisions, I make better ones. It forces me to compare my old portfolio versus new candidates all at once. Typically, at those times you will see a flurry of trades. The second reason I make trades is one a stock has risen 20% above my target weight for the stock, or fallen 20% below my target weight for the stock. I will then typically sell into strength to bring it back to the target weight, or buy into weakness to bring the stock back to target weight. I do not automatically buy into weakness, but I take time to analyze my thesis. If I discover I am wrong, I sell out the whole position. If I'm still convinced of the merits the stock, I buy more to bring it up to target weight.

One more thing: my biggest losses have been on companies that I have invested in, reinvested in, and reinvested in again. I think I've learned my lesson there, but it's not impossible that I might make that error again. The flipside of that error is that my biggest gainers in the past have more than paid for my biggest losers. Rebalancing has often produced for me very low average cost positions on winning investments.

3) I might underperform. I am intellectually honest enough to realize that even though my strategy, as managed for my personal account, beat the S&P 500 by a significant amount over the last 10 years, does not mean that it will outperform over the next 10 years. I am encouraged by the fact that nine out of ten years, I beat the index, and in the one year that I missed, I missed by only 1%.

All that said, I will do my best for you. Also, I will never have less than 50% of my liquid assets invested in this strategy. At present, over 80% of my liquid assets are invested in this strategy.

4) I will aim for tax-efficiency, but might not achieve it. Because of my portfolio rebalancing strategy, I tend to produce capital gains, including short-term capital gains. You can ask me to produce more losses in your account for taxation purposes, or harvest gains as you see best. In order to keep your account like my model composite, I will enter into trades at such a time to keep your exposure roughly in line, by replacing the stock removed with a similar stock or ETF. For example, if we sold some Pepsi, I would replace it with Coke.

Other tax management strategies you can ask for include asking for appreciated stock in your portfolio for charitable donation purposes.

Also, I will do best for those that want to give me cash, not securities, to invest. If you have appreciated asset in another account that you do not want sold, please do not transfer them to me. I have my own management methods, and if you transfer me assets "in kind" and give me discretion, I will liquidate them, and invest them where I see best advantage according to my model portfolio.

5) My track record is not audited. When my assets under management get large enough I will get my track record audited. Until then, you are free to look at my brokerage records for the last 10 years. They are on a password-protected area of my website. I will also prepare in the near term a file that fully reconciles, transaction by transaction, all of the trades and positions

6) I'm quirky. My original goal was to manage institutional assets. But every fund management consultant but I talked with loved my returns, but hated my management methods because they didn't fit their models easily. There are no other managers I know that mix value investing and industry rotation. Also, the fund management consultants did not like the fact that I buy small, midsize, and large companies. They did not like that I buy foreign companies as well as US companies though this is a US-centric fund. Finally, they didn't like that sometimes I look like growth manager.

I usually run with 35 or so stocks. To some that seems overly diversified, to others overly concentrated. I run with 35 stocks because I do concentrate industries. If I ran with a smaller number the risk level would kick up markedly.

Also, I tend to run with about 10% cash. Most fund management consultants want me to be fully invested. I don't do that, because the cash allows me to be more flexible my investing. Also, since my portfolio concentrates industries, the cash allows me to ameliorate volatility. That is useful because most of the time my portfolio would not be considered a diversified portfolio of equities. To the fund management consultants, that raises the risk level, but my view of risk is not determined by the market benchmark, it is determined by margin of safety, industry prospects, and cheapness of the business.

I'm not in this business to please the fund management consultants. I'm in this business to make money for clients on a risk- and tax-adjusted basis. My experience with the fund management consultants was valuable, though, because it taught me that a large portion of the money management universe has its wings clipped, such that they can't make decisions off of pure economics.

7) I have managed my account as "long only" in the past. Any hedged version might not remove all of the equity market movement, or might overhedge. I have run hedging programs in the past as an institutional investor. That doesn't mean when I start to apply this in a retail context that I might not mess

up once or twice. Please understand that hedging will not remove all risk, and in some cases, may increase risk. It is not a panacea.

8) Investing with me is only a partial solution to your full range of financial needs. My main goal is to make more money than the general equity market. For your risk assets, I plan to outperform the market, largely from only taking risks that are adequately compensated. For your fixed income assets, I am offering a strategy that takes only compensated risks. You will need other advisors beyond me for now. I don't plan to consult on asset allocation, or retirement planning.

9) I am using Interactive Brokers as the Custodian and Clearing Broker. Their strong suit is not service. I am using them because I like their low costs, flexibility, and trading technology. I think I will be able to generate better returns for investors using them. That said, it means that I will have to help my clients with sign-up, and provide additional reporting beyond that which Interactive Brokers gives quarterly.

Fixed Income Strategy Issues

10) This is a new strategy with no track record. This is not to say that I have never used the elements of this strategy before; I have used them at prior employers to manage bond portfolios. But I have not done it for individual portfolios. I will be using ETFs and closed-end funds to implement this strategy, mainly to minimize transaction costs. In areas where there are no fixed income investments that trade like stocks, bonds will be used when they can be purchased with reasonable all-in transaction costs.

11) This strategy is very different than most fixed income strategies, because it pays little attention to the need for current yield, and no attention to what fixed income benchmarks are returning. It pays attention to where yields are relative to underlying risks. During times when underlying risks are significant, and yields are not enough to compensate, the strategy will focus on low-yield areas, and foreign currency/bonds. During times of panic, where certain fixed income classes are being thrown away, the strategy will look for opportunity and buy what's unpopular.

12) For average investors, this is not a normal or comfortable strategy. It will seem too conservative much of the time, and too risky when the market seems crazy. There are substantial possibilities for mis-timing on a strategy like this. I will try to reduce those risks by legging into positions when that seems wise, and by trying to be a little late, rather than early, but the success of this strategy can by no means be assured.

Summary

Well, that's all. I hope that you will still want to invest with me, but if not I understand. And I ask you to understand that I will do my best for you, though I know I have a lot of lessons to learn as I manage money for my clients. I have managed a lot of institutional money in the past, and done well at it, but it's a different thing when it is your strategy, and your name on the door.

Sincerely,

David