

White Paper

Is it Time to Change the Way We Invest?

Adversity has a way of revealing strengths and weaknesses, and this is certainly true among financial advisors. The recent meltdown was tough enough for even the most seasoned professionals, but for those who lacked a clean underlying investment philosophy, the devastating sequence of events that began in 2008 effectively deprogrammed them from whatever belief system they had and left them searching for a new “religion” to believe in- one they could report to unhappy clients was more likely to work in this “new world”.

If an advisor is looking to improve their decision making in the aftermath of this terrible bear market, it is important to recognize that simply switching to a new approach that is based on avoiding whatever problems were just experienced (even though it is too late) probably fails to provide a framework to identify and make successful decisions in situations not yet faced or conceived. Remember, an investment approach can't by itself make good decisions, it can only allow for them.

We have always believed that making good investment decisions, even through very difficult periods, must start with a confident and intellectually well founded commitment to a sensibly rational set of investment beliefs.

A good approach:

- relies on analysis and not emotion to make decisions
- is grounded in hard work and fundamental research
- values intellectual honesty and recognizes that uncertainty will always be present, but that we must be able to make decisions in the face of uncertainty, and that accepts that we won't always be right
- is based on principles that remain valid no matter how difficult the period

Our investment philosophy is based on those principles, and we know that they will stand the test of time. This philosophy forms the foundation that guides our decision making.

Core Beliefs Must Withstand Mistakes, Fear, and Paradigms

Providing investment advice is not easy. As financial advisors, we are called on to make decisions about an uncertain future based only on the incomplete information we have today. Meanwhile, our clients' confidence is always at risk of being undermined by the wide range of competing points of view and ongoing stream of short-term news and data that are always available in this age of information overload. Maintaining confidence is critically important, and requires the advisor to honestly convey what can and cannot be known with certainty, and to share the analysis that was used to weigh these uncertainties in order to make the best long term investment decisions.

Our Core Beliefs

The underlying investment philosophy for M.K. Brown and Associates has not changed. Our philosophy is based on a belief in diversification with tactical over- and under- weighting to asset classes, but only when we believe they offer an opportunity for excess return or portfolio risk reduction that is so compelling that the odds are heavily skewed in our favor. Our decisions are based on investment fundamentals, valuations, and are subject to each client's investment objectives. We are long term investors and believe that the vast majority of the time our five-year decision horizon is long enough for our portfolio moves to pay off.

There are Five Basic Tenets that Support our Investment Philosophy:

1. Fundamentals and Valuations Rule Over the Long Term

Investments have value ultimately because they are expected to generate tangible wealth. A bond's value is a function of the interest it pays and the expectations that principal will be paid when it matures. A stock's value is based on the underlying company's cash flow and its ability to grow. Investments compete with each other for investor capital based on expectations about their fundamentals and the risk surrounding these expectations. Ultimately if the reality doesn't match the expectations, their prices have to adjust. The success of our investment decisions depends on our assessment of asset- class fundamentals and whether their prices accurately reflect those fundamentals.

2. Markets can be Irrational- This Creates Opportunity in the Long Run

Markets are driven by valuations and fundamentals over the long run but can be driven by fear and greed over shorter time periods. When investors are overly optimistic or overly pessimistic, asset prices can disconnect from their fundamental value for months and sometimes years. This disconnect is a good thing because it creates the opportunity for M.K. Brown & Associates to add value over the long run. It also requires us to have a high degree of confidence in our tactical position and that our research is correct and will therefore pay off.

3. Patience is Necessary

As already noted, over the short term anything can happen, but longer term the underlying economic fundamentals of an investment will drive return. We're willing to take on temporary short term price risk if we are confident we will be rewarded over the longer term. This means we are willing to look wrong in the eyes of our clients over the short term and that we can perform better for them in the long run. We're also willing to wait patiently for opportunities by holding lower return assets when higher return opportunities are not present.

4. There are Few Certainties in Investing and so Diversification is Prudent

Our tactical approach to asset allocation requires that our investment decisions are supported by odds that are heavily in our favor. However, we will never have one-hundred percent certainty. Moreover, as mentioned, we know that markets can sometimes be irrational for uncomfortably long periods of time. So we limit and hedge our bets against being early or wrong. There is no assurance any strategy will be successful.

5. Having a Broad Opportunity Set is an Advantage

Over time, asset class opportunities evolve and sometimes new investment categories are created. Commodity futures, long- short funds and emerging markets local- currency investments are relatively recent examples. We believe in thinking broadly so that we don't limit our portfolios when new types of opportunities arise.