



The Quarterly Report

Anyone who has invested money can relate to the challenge of maintaining discipline at times when markets are one-sided. Today, thanks to a strong stock market, investors are apt to be willing to take on more risk. During a down market, they are more likely to want to reduce risk until the rough patch is over. But the truth is that risk is counterintuitive: it is actually lowest when it “feels” highest, and vice versa.

As we consider many of the investors we know, even some with a lot of experience and knowledge, we can’t help but be struck by how many of them failed to perceive risk accurately in early 2000, as the stock market bubble was nearing the bursting point. By the fall of 2002, as we reached what proved to be the bottom of a painful bear market, investors saw risk levels as enormous. It’s unfortunate but true that investors see the least risk when risk is actually greatest, and perceive the most risk when it is actually much lower.

Humans are wired to do simple, survival-oriented pattern recognition. Many of the ebbs and flows of ancient life were recurrent—seasons, migrations, appearance and disappearance of food and predators—and our skill at extrapolating suited us well. In the stock market, though, this trait underlies the age-old tendency for investors to get whipsawed (the academic field of behavioral finance studies how these human biases lead to decision errors). Investors decide to buy after a strong run convinces them that they are missing opportunities, and decide to sell after prolonged periods of weakness destroy their confidence and convince them that the bottom is nowhere in sight. And unfortunately, these periods often occur in the neighborhood of market tops and bottoms. Warren Buffet quipped that stocks are about the only thing people avoid when they go on sale. Most successful investors are able to

ignore the emotional pull that occurs as the markets cycle between fear and greed—not simply for the sake of being contrarian or because they have cast-iron stomachs, but as a byproduct of a process in which they seek to buy stocks whose prices are sufficiently low relative to their prospects to suggest that over time they will earn a good return. In short, they have a decision framework that gives them a consistent basis on which to decide when to buy and when to sell an investment (more on this in a minute).

Think back to early 2000. After almost two decades of mostly rising stock prices, and fueled by belief that we were in a new economy in which technology had changed the landscape forever, investors’ perception of risk was very low. Even as valuations reached levels that defied logic, investors rushed to buy stocks. A look at fundamentals at that time revealed that many stocks were priced for perfection—in other words, everything had to go exactly right for many, many years to come if that valuation was going to prove to be “correct.” Less than three years later, investors were driven by fear instead of greed, and still were not focused on fundamentals.

Why are fundamentals important if investors ignore them anyway? Because over longer periods of time (at least several years) emotional influences wash away, and the forces that lead prices and fundamentals to converge are dominant. This is crucial for investors to remember, since it provides the most basic foundation for a decision framework. Imagine if you knew precisely the fair value of a stock at a point five years into the future (analysts try to get at this by determining the present value of its future earnings stream). If it reached that price after a year, there would be little incentive to continue to hold the stock. If today that stock were selling for only

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Summer Intern!**

Courtney Tull is providing valuable back-office support this summer before she tackles her next adventure as a freshman at Oral Roberts University. For a brief history of her last eighteen years, visit: www.TullFinancial.com/CST

<i>Mutual Fund Yardsticks</i>	<i>One Year</i>
S&P 500	20.59 %
Average U.S. Stock Fund	18.26 %
Average Foreign Stock Fund	29.61 %
Average Bond Fund	6.36 %

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half of its fair value five years hence, you would back up the truck.

Of course, markets aren't that certain. It's difficult to determine what a company is going to earn, and there are many variables that play into investment returns. But the broader point remains valid: investment decisions based on hope, fear, or greed will lead an investor to buy when others are buying and sell when others are selling—a guaranteed way to get terrible investment results—while decisions based on a return expectation that's derived from rational analysis help support a disciplined, consistent approach that is far more likely to succeed over time. Investors who aren't willing to conceive a process to guide their investment decisions have little insulation from the powerful emotions that drive the market over the short term. Realistically, they'd probably be better off saving than investing.

In the end, individuals have the ultimate say over the investment decisions they make or allow to be made on their behalf. If you can start to think about investing in the context of a decision framework that correctly views lower prices as more attractive and higher prices as less attractive, then you are going to find it easier to make good, consistent decisions. This is easier said than done, because prices become more attractive when sentiment is negative and less attractive when sentiment is positive, and so making good investment decisions almost always "feels" wrong. But over time you can learn to think differently. You may find yourself thinking proactively about opportunities, instead of reactively about having too much exposure when the market is weak and too little when it is strong. You will start seeing and doing things differently from everyone else, which in the long run is how you succeed in investing. ~ ~ RWT

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**Tull
Financial
Group**

640 Independence Pkwy.
Suite 300
Chesapeake, VA 23320
Phone: 757.436.1122
Fax: 757.436.1803
Toll Free: 888.296.PLAN
www.TullFinancial.com

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