

Winning in Today's Stock Market— A Classic Approach.

***by Matthew Shapiro,
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I am here today to show you how to win with my Classic Approach. With my strategies you will have a chance to beat the market. You will create upside the average investor does not have. And this upside is the key point. Because while you may just track along with the markets, you can beat them with a quality portfolio of well selected stocks—The Classic Approach for Today's Markets.

Why a Classic Approach? Stocks and bonds held for the long run? Are we serious? How can a 38 year old adviser talk about Classic! Too many people embark on an unsound investment plan trying to beat the market, and more insidiously are talked into the wrong investments by brokers or financial agents who promise high returns. For the people who chase returns, my first advice is that the best way to beat the market is to not try to beat the markets at all. We can plan on winning, but beating the market is not the point of investing, setting up for long term results is the best strategy.

One of my first clients was my close friend Dr. Dave. I took over his portfolio in late 2003. At the time it was heavy in the big cap techs from the Internet Bubble. In fact, even though he had bought near the bottom, and he had pretty good ones like CSCO and EMC, he was still down about 25%. Imagine a portfolio 100% in tech today—unthinkable! Maybe the way to go this year!?

When I took over the account, it had built up a large cash position. Being new to the business of managing money, I planned to invest slowly. But Dave calls me one day. Understand Dave is not an especially savvy or well informed investor, just a practical guy. He says to me “*why aren't you buying anything? The sooner you invest the quicker you will get it working for me!*” Those were the best words anyone ever told me about managing money. Get money going into productive assets ASAP. Don't try to time it.

I set about balancing his techs with Blue Chips, financials, and dividend paying stocks, mid and small caps. I used 10% Inflation Indexed Bonds. Dave is a young guy, early thirties, making good money, so I had the luxury of him steadily funding his account. Every few weeks \$5-10k would show up. I would buy the best stock at the time.

I must have killed it right? The market rose despite pullbacks in 2004 and 2005. I didn't. Dave's account actually lagged those of my other clients! Because he had risky stocks—the old techs—I would buy safer ones as I filled out his portfolio, but to this day there is no explanation except the variability of returns between actual portfolios. He did keep up with the markets, he just did not beat the markets, when many other clients were.

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Something funny happened in 2006. With a portfolio having grown far larger than it ever was, Dave's account ripped off a 20% year! With 10% in bonds, and high security quality. The risk adjusted performance was off the charts. Just beating the market one out of three years is all you need to have winning investment results. These results are not possible just using ETF's or mutual funds. You need The Classic Approach. Well selected stocks and bonds that take advantage of today's markets.

Unfortunately what I call The Four Central Myths of Investing prevent most from discovering the secrets of The Classic Approach and the principles that make it so effective.

Myth 1. The Next Big Thing: Many believe that the only way to make money in stocks is to get in on the ground floor, buy the next MSFT, or invest in a new technology or new product. This is the worst way to invest. Serious new technologies take incredible amounts of investment by

major companies, and they take years to pay off, if ever. This Myth can also cause investors to fall for completely speculative stocks. Many are focused on energy. I took over a portfolio with a \$5 stock called Plug Power which is involved in “proton exchange membrane fuel cell and fuel processing technologies.” I am usually pretty easy going with old stocks in a portfolio. I rarely sell them. But PLUG started to bug me. It had revenue of just \$2m a quarter on a \$300M market cap. I sold ½ at \$6.12 and kept a small speculative position. Maybe it had some merit after all. I made some calls about its products after it started going down. This is what I found out: Forget about “proton exchange membrane fuel cell and fuel processing technologies.” PLUG just sells a backup generator powered by hydrogen tanks. They work, but they cost more than traditional battery or diesel units, and they can only be installed outside and not inside a facility. The only market seemed to be the occasional utility or Phone Company trying to be ‘Green.’ This was not a proprietorship that could sustain a \$300M capitalization for long. GE or Honda can put extra effort into making ever more efficient diesel units. I sold the last at \$4.11 and it is now \$3. *Stocks are not about technology. They are about a business, a proprietorship that can make money. Buy into a business--with great potential sure-but not a dream.*

Myth 2. You need to take a lot of risk and trade continuously: This myth misunderstands how return is made in investments. It advocates continually buying and selling based on the latest swell of fear or hope, earnings #'s, analyst report, or CNBC show. It seems to get people to get into the same stocks as if these are the only stocks that matter. The mantra is ‘take a quick profit, sell if it turns.’ Return comes from the assumption of equity risk over time, not from trading acumen. It is your ownership in a business that makes you money. Trading does not help. If you hold stocks, you hold stocks whether you trade them constantly or not at all.

Myth 3. The Doomsday Portfolio: Some people think the World is going to end, or that our economy will collapse. I can give them investment advice. Buy shotguns and ammo, cases of chocolate and Marlboros, some gold coins and a Toyota truck, and finally, bottles of Viagra. With this you will be prepared for the End of the World! If you are going to be a successful investor you need to have a positive outlook for our country and the World and be able to look on the bright side when things seem tough.

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Myth 4. You can't make money in a developed business: The best example I can give here is last summer on The Noon Business Hour a guest stock strategist was asked about MSFT @ \$24. His opinion: “At this point I don't believe Microsoft has any investment merit.” In contrast to his opinion, shares in the largest and most successful business in the world advanced to \$31. A gain of 30% with little risk. That's about the most investment merit I have ever seen! Oftentimes, the larger and more organized a company is, the more leading its brands, the more it can draw on economic growth and produce profit for itself, and for you.

Now that I have dispelled these myths we can see the true secret of The Classic Approach. This secret is very simple. It is called The Magic of Appreciation. What is The Magic of Appreciation? Simply put, it is that assets that have value today tend to appreciate over time, sometimes dramatically so, and far more than we might have expected. It says that we can never put a value on the future. Stocks are claims on the future and the future is unbound by today's knowledge. Something you buy now can be worth far more than you ever expected.

Morningstar: MORN-- \$50

My last example is from my personal experience. I had always wanted to own my own seat on the Exchange. When I first started trading, seats on the CBOE were about \$750K. Then the Intent Bubble crashed, then 911, and then electronic trading and competition swept the Exchange. Many traders were driven off the floor. In 2002, seats already down to \$350K suddenly dropped to \$250k. For the first time since the Seventies. I convinced my boss to buy one with me. I had enough money for a minority share. In the next few months the seat dropped to \$150K. By then even I was off the floor, having started my investment business MWS Capital. But the seats inexplicably steadied and moved up, and rents on the seats surged. One day in 2004 they hit \$400K. My old boss called from New York, said they were thinking of selling, I told him not to sell, that I considered it a long term investment. But I was only the minority partner. Later that day they sold the seat at \$400k. With seat lease income, I nearly doubled my money in two years.

Pretty good right? But I never wanted to sell. I considered it a long term investment. That seat is now worth \$2M dollars. Including income about nine times over in less than five years. The Magic of Appreciation. *Something you buy now can be worth far more than you ever expected.*

Don't settle for the first 20%. The fun part of the stock market is sitting back and seeing your winners double or triple, or go up ten times over through the years. It happens because of business or economic developments that you could have never anticipated. Keep in mind time. It doesn't happen overnight and you can't exactly plan or control it. So to capitalize on The Magic of Appreciation you must act uniquely. *You must be what I call a patient collector of quality assets.*

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When I analyze a stock I am trying to assess its quality and character as if it were a gem among many. I am looking at the whole picture of a company.

I am not just putting a value on shares. Certainly I like to buy more for less. But The Classic Approach finds permanent investments, so near term valuations are meaningless over time. Can I on average buy stocks of higher relative quality and lower risk? Yes, that is my goal—but I let the natural forces of the economy and the markets take care of the rest. The Magic of Appreciation works through fundamental quality.

About value: I am a professional investor; I will buy stock at thousands of points over the next 40 years. I think you will agree on average I will buy stocks at fair prices over this period. There is no way I could say I would only be buying these hundreds of stocks at thousands of points in time under intrinsic value. Even if I did accomplish this-in my mind—it would mean that I would have to sell all the time after they reached some so-called 'value.' That is no way to manage a portfolio. Selling a stock that goes up 10-20% doesn't help. I have stocks that go up 100% all the time. In mature portfolios I hold stocks with huge long term gains.

Precision Castparts: PCP-- \$100

What exact numbers do I use? Is there any particular metric? Yes: In the end the overall metric I use is the relative risk of a stock given my assessment of its quality. This is subjective! People pay me for my own opinion. I have my preferences. I like industrials and important corporations with long business histories. I tend to shun fads, retail, and financial or business combinations. I am trying to find pieces of the economy where I can place funds directly into the hands of corporate management. Not into the hands of a Hedge Fund manager. The Classic Approach requires you to be a patient collector, to have your own vision.

How can you differentiate when you look at your stocks on Monday? The best illustration is something I heard from Warren Buffet. In an interview he was asked what he looks for in a company. His response? "Well I am like a basketball coach: Thanks, but I am not interested to know that you can play. I am looking for 7 footers!" 7 footers-- this is powerful. *I do not care if you can shoot—I am looking for a pro. 'A 7 footer.'*

Keep the pro scout concept in mind. Truly unique athletes. Sound financial position, profitability, products, and management. Ever seen the swing of a PGA Player? You can tell the difference. Take this vision with you like a swing thought when you are attracted to a third tier stock that seems interesting, but overlook an All-American market leader with far greater resources at 52 week low. Look for outstanding quality.

Johnson & Johnson: JNJ-- \$60

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The most important lessons today are my Secrets of Portfolio Management. The Classic Approach blends well with Modern Portfolio Theory. These Secrets are the key to maximizing return while keeping risk under control.

The first question is whether or not you like stocks or bonds. Can you handle the risks of stocks? Do you prefer the safety of bonds? No right answer. Depends on you. No one can tell you have to be in stocks if don't like the volatility. Even if you are young. If you like stocks, you don't have to be in bonds just because you are retired.

Something I want you to think about is that stocks and bonds share the same financial risk. At the end of the day they are investments in the real economy. But this is the difference. Stocks have higher expected return because you don't know when you get it. You also risk a substantial loss. Bonds give you a lower expected return in exchange for certainty in the timing of return. You have a nearly certain return of principal. You can do well in both. Various mixtures and combinations of the two are essential to high end portfolio management. Sometimes interest rates make corporate bonds attractive, other times, like now, with the 10 year @ 4.5%, I prefer a combination of T-bills @ 5.10% and Blue Chips.

My objective in portfolio management is reducing risk and enhancing return. It doesn't matter whether or not the goal is conservative or aggressive, income or equity. You have to limit risk. And the only way to truly limit risk is with cash and T-Bills. All other risk reduction techniques are secondary. The amount of cash is the first degree of risk reduction. I usually keep 10% even in an aggressive stock portfolio.

The second degree of risk reduction is the amount of Bonds overall. Including cash. The amount of bonds dramatically reduces fluctuations in an account. For most middle age people 20-30% in cash and bonds gives them most of the return of the stock market, but dramatically reduces volatility. Be careful about high yield bonds. Unless the portfolio is income, say 60% in bonds--they count toward equity risk. Please don't try to reduce the risk of a stock portfolio with high yield bonds! It doesn't work. I see this all the time, especially when portfolios come over from brokers selling loaded funds. Their fees are so high, they put income investors entirely into high yield despite the danger. For all the fees and risk they get the return of CD's! That's a fiduciary violation by my standards.

Once relative risk is right, the right amount of bonds and cash, we can turn to the composition and quality of the stocks. Quality is the most important factor for reducing risk. Here are my 3 secrets measures of quality. 1. The size of the company. Big sales, big profit, big book value--less risky than no profit, no sales, no book value. 2. The percent it pays in dividends. Bigger dividend equals less risk. Obviously adjust if it is a high yield style payout. 3. The actual dollar stock price. More is safer and less volatile. \$50 dollars versus \$5. Other measures like growth, PE, cash flow, price to book or sales are important in judging a stock, but the general quality of your portfolio is best judged by its average yield, stock price and capitalization. Doesn't mean you can't buy a \$9 stock or a growth name. Just try to get your average higher. Budget risk among your stocks. My 7 stocks today have an average price of \$50, average market cap of \$48B and yield 2.6%. The Magic of Appreciation will catch quality. You don't have to be in little stocks to do well.

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Royal Bank of Canada:RY-- \$50

Other risk reduction techniques such as foreign stocks, metals, real estate, or even derivatives--can be helpful. But minor to the first three degrees. You may sprinkle in 25% ETF's or low cost funds. Depends on the size of your portfolio. This will help reduce your tracking error versus the markets. It is less necessary in larger portfolios with about 40 stocks.

I like to keep a central focus in a portfolio. It's like a soccer team: I have strikers and defenders. The focus depends on the client and today's markets. Could be Aggressive, or US Core, or foreign focused, or technology. I also keep a Sector composition. I do not just focus on hot areas, or just growth or value. My 7 main areas that I pick from are: Financial, Industrial, Dividend, All-American, Tech, Medical, Specials. I try to include some from each, with a central focus in one or two areas.

Lifeway Foods: LWAY-- \$9

It takes a lot of stocks for true diversification. The higher the risk in each stock, the more you need to effectively distribute those risks. Don't worry that your best ideas are watered down! The most important thing is the shape of your sail. You can always tune your portfolio to be more or less aggressive. A great deal of a portfolios out-performance will come from the 10% of the stocks that do really well. If there are not enough securities you will sell the big winners too early.

Buy and hold. Don't sell. Only trim back, or cut a loser if you like something new. Short term trading has little value. Securities are fairly priced. Just because something went up you don't need to sell. You were right. Hold on to it. All the winners I trim back nearly always go higher. Would you uproot a cherry tree after it starts producing fruit? Of course not! You might trim it back a little to fit into your landscape, but you leave it to give you fruit.

The Classic Approach takes advantage of two phenomena of modern financial theory. The final piece to winning with The Classic Approach is an independent assessment of risk in today's lightning fast electronic markets.

First, investors tend to overpay for risky assets. But they pay too little for assets that are less risky. Some people like to pay for flash, thinking they will make a quick buck, and some people love to gamble. I have an old trading buddy John, who has been knocking around in what I call the underbelly of investing Out West. One short job he had was making hundreds of cold calls a day offering limited partnerships in speculative oil and gas wells. These are \$100k lottery tickets. Evidently one in every few thousand people will fall for this scam.

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There is an appropriate price for risky assets. However, complete speculations, like the oil and gas prospects, are unlikely to be priced fairly. If you play poker you know there is a value for even a marginal hand. They can win big. Assets are priced the same way. However, some investors exclusively seek the riskiest assets looking for high return. The riskiest assets attract a segment of investors pushing up their relative price because of their desire for more return. In good times the price can be far from an objective estimate of value.

Miss-pricing of risk can have a subtle effect on even we would like to buy for ourselves. I like tech stocks, high yield bonds, commercial real estate, and Emerging Markets. *If the price is right.* The Classic Approach avoids sectors of excessive past returns. Because at some point the easy, comfortable, assumption of risk has likely infected the pricing of a whole asset class. After years of gains, professional managers overpay and concentrate risk on behalf of eager investors fueling their funds. This explains this year's Amaranth hedge fund disaster. The commodities boom placed a young trader able to push the limit in the natural gas markets at the controls of billions of dollars of pension investments. At precisely the wrong time. An article from the WSJ on Feb 22 warns that "Central banks concern is that investors are under-pricing risk." Bidding up prices of risky assets beyond the return suitable for the risk. March's correction was nervousness about thin risk spreads in high performing assets.

Be careful when risk premiums seem thin and prices are high. Prune back small caps, high yield bonds or Emerging Markets. Less risky assets like Blue Chips and Investment Grade Bonds will represent far better value for you.

Penn West Energy Trust: PWE-- \$30

We conclude today with the second phenomenon of modern financial theory. It is the true killer of investing. Any guesses? Selling at the bottom? It is not overpaying for risk. It is that what we thought were good investments ended up just being bags of cotton candy sold at the Carnival. This is the killer, investing in pockets of hot air, unreasonable expectations, instead of timeless investments. Deflated expectations—once they are gone, they are gone forever. You

can never recoup them. We are talking about asset bubbles, manias and fads- complete speculative abandon of an order far different than just inappropriate risk premiums.

We are too smart to get caught in a bubble, right!? Sometimes they are hard to see, but more so they can be hard to resist. In 2002 I bought Lucent at \$50, after the first few breaks in the tech market. I thought I was buying something solid, investing responsibly. It was Bell Labs. I am from New Jersey, around its headquarters, my friend's parents worked there. Lucent went to nearly nothing. I would have been ok had I just bought CSCO. I did not know about the accounting shenanigans at Lucent or the extent that their goodwill represented the unreasonable expectations of the Internet Age.

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Despite the lessons of financial history we can't help to create bubbles, and it is easy to get trapped in them. If you need a house in DC you have to pay up even if you think prices are outrageous. Lately there has a mania and fad even in the diversifying investments like REITs and Emerging Markets that are supposed to be good for our portfolios. Now they have gone up well beyond comfort. Again these are hard to spot and resist. There are always arguments that valuations are still compelling. India and China are growing rapidly; aren't we missing out if we do not invest there? Major companies like UPS and FedEx are expanding operations in these markets. They must know. If you are a money manager and you were skeptical about Emerging Markets the last three years, the competition was eating you up. You feel you have to be there.

Canon: CAJ-- \$50

In the case of commercial REITs, we have now had the largest acquisition ever with private equity firm Blackstone buying Sam Zell's Equity Office Properties for \$39B. Much of this has been spearheaded by one man, Jonathan Gray, considered a 37-year-old rising star within Blackstone's real estate group. He has led a series of larger and larger acquisitions on behalf of his firm. Just like with the young Amaranth trader mentioned before, there will always be a manager willing to push the limit. REITs are great in portfolios-but I think the prices are too high now, and the prices are high just because too many people think commercial real estate is a diversifying investment they must have. As reported by BusinessWeek: Citigroup analyst Jonathan Litt notes that REITs now trade at a two point multiple premium to the S&P 500 when historically they trade at seven point discount!

The REITs case is tough, because to conclude today by tying together our discussion of speculative bubbles and risk premiums, it is Blue Chip Investments, of which the larger REITs are great examples of, which are far less susceptible to being overpriced or overvalued by investment excess. Typically when you buy a Blue Chip, or even a smaller company of some redeeming economic quality, you can be more certain you are buying something of lasting value that you can put away and wait until the Magic of Appreciation lifts the price for you.

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