



Portfolio Composition

Part I – Investments that Generate Wealth

All companies we invest in must consistently produce operating profits in excess of their cost of capital, the most important driver in **generating wealth** for shareholders. Businesses that consistently produce profits in excess of their cost of capital also give us a higher degree of certainty in our expectation of return. Of course, valuation matters and that is why we strenuously test future earnings potential against the current stock price. Generally, a high return on capital business is expected provide significant capital appreciation for investors. However, we are keenly aware of the benefits of receiving consistent cash dividends, especially when market conditions dictate more conservative investing.

Investment-grade bonds will generally produce lower long-term yields than stocks. The return of principle at maturity, plus a recurring cash yield, generates consistent compounding. Because investment-grade bonds have a very high degree of certainty for repayment in the future, they generally fluctuate less than stocks over time, especially the closer they are to maturity. Every bond investment we make is subject to a credit and liquidity review, in addition to our return on capital analysis of the underlying business. We intend to hold bonds to maturity, while seeking the most reasonable yields available, given the structure of the yield curve and our expectations for inflation-adjusted returns.

Part II – Balance and Capital Preservation

The history of the stock market from 1924-2009, shows impressive rolling 1-year average returns of 11.73%¹, including dividends. This number is often built into asset pricing models to represent investors' expectations of return from equities. However, there have been long periods where returns have deviated significantly above and below the average. It is primarily those periods of subpar performance that should concern investors most. Given the finite period of time when an investor can save, invest, and take risk to maximize long-term return potential, extended periods of loss can derail future financial goals.

Consider that at the end of 2009, the total cumulative return over 10 years from the S&P 500 was *negative* 4.35%. At the lows in early 2009, 10 year total returns had actually reached negative 24%. However, on a monthly basis since 1924, the average rolling ten year total return is 142% for the S&P 500, roughly a 9.2% compound annual return. That makes the decade ending in 2009 an extremely unusual event. Indeed, of all rolling 10 year periods from 1924 to

¹ Calculated from the data of Robert J. Shiller, used in *"Irrational Exuberance"*, Princeton University Press, updated 2010.

2009, less than 1 in 10 have registered negative returns. While some investors' lifetimes have had the benefit of above average returns, those who are trying to save and invest in the first decade of the 21st century, for example, have not been so fortunate.

When considering the returns of 10 Year US Treasury Bonds, the average rolling ten year total return since 1924 is 52%². For the 10 year period ending in 2009, the total return was 63%. An important difference in the character of those returns from that of the stock market is that, when held to maturity, there has never been a single period of loss. Of course, that is what defines a risk-free security, but it is an important statistic to understand. If an investor can purchase bonds with very low risk of default (i.e. high-grade corporate debt), a consistent yield can be generated within a portfolio of investments.

While equities usually provide significantly more favorable long-term compound returns, we are focused on building in reliable and consistent yields from bonds as well. It is clear that timing is vital when looking to participate in the long-run average return from stocks. There are periods of time, such as the past decade, when having a consistent yield underlying the portfolio, no matter what the age of the investor, is critical. Given ever changing risks in the economy and markets, a balance between bonds and stocks may often fluctuate given the current opportunities available for investment.

There are times when **preservation of capital** is more important and cash investments become preferable. We do not try to time and trade the markets in the very short-term, but when stock valuations and bond yields are not acceptable, given the risks we can see, we generally prefer low yielding cash over the risk of loss, regardless of market momentum. Nobody has perfectly clear visibility of the future and the greatest investment risk is that of the unknown. Understanding the reasons for each investment made as well as the prevailing macro-economic risks, is essential to managing any portfolio.

For further inquiries or interest in becoming a FalkerInvestments client, please visit our website at www.FalkerInvestments.com or email us at Invest@FalkerInvestments.com.

² Return does not include reinvestment of interest payments. It is the sum of all interest payments received over the 10 year period divided by the original investment at par.