

The Portfolio Reporter

A Newsletter Provided by Dunn Capital Management, LLC

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The economy and the stock market have remained resilient to hurricanes and higher oil prices. However, how long this resiliency can last we do not know. It is because of this uncertainty we are choosing to hunker down and take a more conservative approach. This means keeping our investments in international funds such as Europe, Latin America, and Asia; keeping investments in oil commodities and utilities; and decreasing exposure to the United States by selling these funds or purchasing inverse or short funds to protect principal. During times of increasing inflation, interest rates and oil prices have seldom provided investment profits in the stock market. Consequently, we prefer to remain conservative in the face of uncertainty.

The ravishing destruction that Hurricane Katrina, and now Hurricane Rita, brought provides a vivid picture of how statistics can only work so well. What do I mean? The levees in New Orleans were built to sustain a category (cat) 3 hurricane. Ultimately the decision not to build the levees to protect against a cat 4 or 5 hurricane must have come down to the cost of protecting the city from a higher category hurricane being much more prohibitive compared to the probability of one hitting the area.

The probability of a cat 4 or 5 storm was based on historical records. Historical records only work so well, however, because environmental changes affect the *actual* probability of storms. Therefore the **actual** probability of a storm of greater magnitude than the levees could withstand turned out to be much higher than the **historical** probability on which engineers and politicians made the decision. Similarly, some residents of Central Texas were wiped out twice just 4 years apart when they experienced 2 “100-year floods” in October 1998 and July of 2002.

The same effect of using the historical probability rather than knowing the actual probability holds true for investing. This played out back in 1998, when the now infamous Long Term Capital Management company, run by two economic Noble Laureates,

Exchange Traded Fund Market Performance - As of Sept. 30, 2005

	1 Month % change	12 Month % change
S&P 500	0.4	9.9
S&P 500 Growth	0.2	8.4
S&P 500 Value	0.6	11.3
S&P 400 Mid-Cap Growth	0.5	20.1
S&P 400 Mid-Cap Value	0.6	21.3
S&P 600 Small-Cap Growth	1.4	22.9
S&P 600 Small-Cap Value	0.0	16.9

imploded because the managers relied on historical probability. They believed that the historical probability of a destructive event was much lower than the actual probability that was demonstrated in the events leading to the demise of their company.

In Long Term Capital’s defense and in defense of using statistics to make a decision – **it is the best we can do**. It is the best information we have to make a decision. Nevertheless, there is something that we can do to guard against imploding.

We must realize that, as investors, we are not immune from disaster. “Low probability” does not mean “no possibility”. This is why there is **ALWAYS** risk in investing. While we try our best to guard against such catastrophic events, there are no guarantees in selecting investments (unless of course you can find an insurance company you can pay to protect your capital like you do your car, home, jewelry, annuities, etc.). All we can do is heed the fact that we can be wrong, realize our mistakes when they occur, and limit the destructive impact of the wrong decision.

All numerical data has been provided by Barclays Global Investors, unless indicated otherwise.

Please feel free to pass the “Portfolio Reporter” to interested friends and family members.

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