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STOCKTOBER

"The stock market was good then," people say (whenever "then" was). "But what about now?" Good question. Owning stock is akin to being a business owner dealing with risk, uncertainty and change, with all the worries and potential rewards that implies.

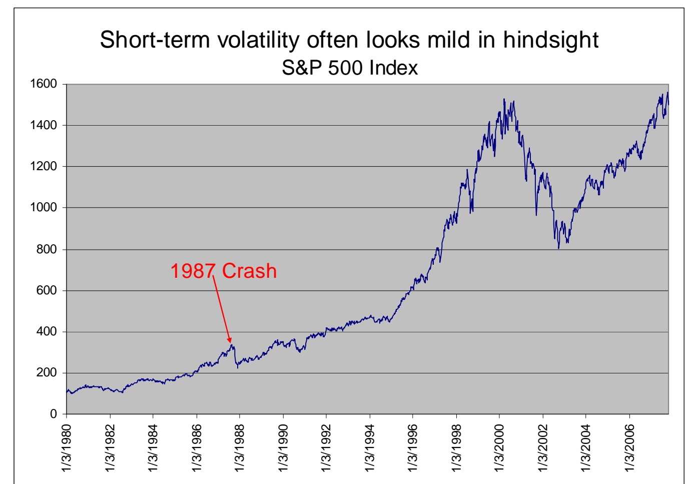
There are many kinds and classes of stock. In general, it's a part of a corporation's capital and gives the owner the proportional right to share in the company's earnings and assets. Stock represents a shareholder's hope for the return of capital and more in the form of a dividend stream plus special dividends – such as cash you get if a company is bought. The time horizon on stocks is very long: a stream of dividends flowing to you and your heirs potentially forever. Given that the present dividend yield on the S&P 500 stock index is 1.8%, below our inflation rate, investors must be expecting a bigger payoff at a future date.

What payoff? One might argue the future event is the sale of your stock to another investor. But that investor needs some reason to buy. Stocks have intrinsic value based on the expectation of future cash flows to the investor, tempered by the market outlook, shares for sale, and the demand for that stock and all stocks.

Over the long term, stocks have provided a significantly greater return to investors than bonds or cash. In fact, keeping money in cash guarantees losing ground after inflation. On the other hand, stocks come with significantly more risk than cash or bonds. The key risks are:

- **Volatility**. Stock prices tend to shoot up and down in both bull and bear markets, with long periods of treading water in between. In any relatively short period such as one or two years, an investor easily can see the value of stocks go down.

- **Specific company risk**. In late October this year, the FBI raided the offices of Wellcare Health Plans and the stock plunged 60% in one day. Big blue chips can suffer drops, too: Merrill Lynch stock cratered 35% as investors found out the extent of its subprime mortgage woes. Qwest dropped 14% yesterday.



Diversification helps with both risks (more on this in another letter). But even entire markets can sag for a while – sometimes for 10 years, as happened to U.S. stocks in the 1970s and Japanese stocks in the 1990s. Investors are paid well for bearing these risks: From 1926 through 2002, the average annual stock return (represented by the S&P 500 index) was 11.7%. Sure beats the 4.4% 10-year Treasury bonds pay. But, you have to have the patience and courage to withstand those scary days when a bear comes rumbling along.

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