Emad A. Zikry, President and Chief Executive Officer

Sell Everything and Take a Vacation

No, I haven't completely lost my mind. The point of this essay is that we are all human and we have common, natural characteristics. Primary among them is that we, by nature, accommodate change poorly. One aspect of this is that we have an inherent tendency to be overprotective of what is ours: our children, cats, dogs and, to the point of this essay, decisions. In a general sense this tendency is not terribly dangerous (although it can be very tedious for those around us), but for a portfolio manager it is poison. Being overprotective of our previous decisions creates a filter of sorts for new information received and how we process it. This is an interesting point, but why does it mean I would be better off selling everything and taking a vacation? It means that because then, when I got back, I would have to make fresh decisions about what to buy free of the emotional baggage of previous actions.

This is not, I regret to say, an idea for which I can claim credit. Bernard Baruch, an investor of no small repute, would upon completion of each of his major investment moves, sell his portfolio. Then, as he wrote in My Own Story (Holt Rinehart Winston 1957), "…shake loose from Wall Street to go off to some quiet place where I could review what I had done." About twenty years later (January 25, 1977), Barton Biggs of Morgan Stanley wrote about what he called "the first year performance phenomenon" of mutual funds. His research showed that during the period of 1965-1970 a disproportionate number of the top performing mutual funds were in their first year of existence. As an example he cited 1968, when the top three funds and nine of the top thirty funds were brand new. None of this is coincidence he argues. Rather, when a portfolio manager is confronted with the challenge of deploying cash, she can make fresh decisions and fresh decisions are not prejudiced by the residue of previous decisions. That is they can be made without any bias toward defending what one has already done. Thus, the framework of the decision can commence from words like *current*, *present*, and *today* then advance into the future, thus denying legitimacy to the misjudgments of the past.

As a more specific example, let me digress with a story from when I was an earnest young man just starting in the investment business. In the mid-Seventies I was working at one of the more venerable investment management firms in New York as a very junior portfolio manager. During one of the firm wide scheduled breaks, (Yes, I do mean firm wide scheduled breaks. A sign of just how dramatically the investment world has changed.) one of the senior guys was talking about a recent meeting with a client from Texas. During the course of that meeting the portfolio manager said that he had proposed the sale of some Lubrizol stock that the client had held for some time. The client paused and reflected for a few moments then slowly drawled " Mr. X we cain't sell Lubrizol, it's like an ol' friend." My somewhat cloudy memory recalls that we didn't sell and his portfolio paid the price.

Obviously it isn't practical for everyone to sell everything and take a vacation, although the IRS and a spendthrift Congress would no doubt endorse the plan based on increased revenue. It is, however, vitally important to *mentally* sell everything at the start of *every* day. Equally important is keeping one's mind clear, focused and forward looking when deciding what to do for the future.

Odds and Ends

Just for fun, here are some random (and often obscure) bond market related questions from the past that will separate the real basis point connoisseurs from those who dabble. (Answers below.)

1.) If you know the answer to this one you've shaved a lot of basis points in your day. What do Nickels, DC-10's, James Bonds, and Bo Derek's have in common?

2.) Standard & Poor's has downgraded more issues than it has upgraded for 13 straight quarters. What was the previous record for number of quarters, and when was it?

3.) What was the shape of the trading desk over which Mike Milken presided back in Drexel's hay day?

4.) Who were Dr. Gloom and Dr. Doom?

5.) What are "HTG" yields, and who invented them?

6.) What was the "12 year convention" that was used to price GNMA's back in the 1970's?

Answers:

1.) All are nicknames given to Treasury long bonds. Nickels were the '05's. DC-10's were the 10's of '10, so named because they crashed on take-off as a real DC-10 had done recently. The James Bonds were the '07's. Last but not least, the Bo Derek's were the first 30 year "10's", and named after the movie.
2.) The previous record was 11 straight quarters in 1989 – 1992.
3.) The trading desk in L.A. was shaped in an "X", so Mike was at the true center of all that was happening.
4.) Al Wojnilower, and Henry Kaufman, who were the chief economists at First Boston and Salomon Brothers respectively.
5.) "HTG" yields were "Honest-to-God" yields invented by Dexter Senft at First Boston. Because they took prepayment variability into account they were a huge leap forward in mortgage security analysis.
6.) The "12 year convention" assumed that every mortgage in a given pool paid its' interest and principle payments until the twelfth year, at which point they all prepaid at once. One can see why "HTG" yields were a great step forward.

Vanderbilt Research Team