



CAPITAL PERFORMANCE ADVISORS, LLC

CAPITAL IDEAS

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The Difference Between Stocks and Socks

This is the time of year when many magazines have articles on the 2004 “best buys” for items such as automobiles, appliances, televisions, clothing and computers. Buyers can find this information helpful in learning more about the specific features of various products. Many of us also spend considerable time checking out the desired product for ourselves before deciding how to spend our hard-earned funds. We read *Consumer Reports*, talk to friends, take test drives, and go shopping to physically see and touch the items we desire.

All of this due diligence is generally important when buying tangible goods. The research takes time, but it is rewarded because we, the buyer, will be the ones using the product. Even though others purchase similar products, their acquisitions will neither help nor hinder our enjoyment of our own purchase. Future improvements or price reductions may make us wish that we had waited (if we in fact remain informed after the purchase), but we still have a thoughtfully purchased, useful product to appreciate.

In short, researching specific hard assets before making a purchase is a wise decision — comparing one stereo or car to another — since the value derived from using such products will be determined primarily by how thoroughly *we* enjoy the tangible good.

In stark contrast, we caution investors to *avoid* spending similar time and effort on researching individual equities to hold in their portfolios. We caution against worrying about the current popularity of Amazon.com versus eBay stock, or auto industry versus electronics stocks. We advise investors to ignore financial magazine articles on the latest hot stock and mutual fund tips, and to tune out brokerage research reports, supposed media gurus or whatever latest investment trend their friends are bragging about.

Why do we suggest there is such a difference between researching the purchase of stocks versus socks, so to speak? First, the reason for making the purchase is (or should be) quite a bit different. When we buy a stock or mutual fund, we only receive a certificate or book entry on our financial statement. Nothing we can really take out for a spin around the block. While we may earn dividends during the time the investment is held, the real purpose (value) is achieved when we sell the asset — we hope it will be worth more when we sell it than it was worth when we bought it. This differs markedly from the purchase of a tangible asset that we essentially plan to enjoy and use up over time until it is of little or no value to anyone.

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Further, the future value of an investment is not based on how much mileage or loads of laundry were achieved, nor on how much *we* feel our holding is or has been worth. Even if we successfully conduct extensive research that enables us to predict future economic trends and company profits, the stock is still valued on what others believe (what “the market” believes) the investment is worth at the time of the sale. Unlike a hard commodity such as a specific automobile, an equity’s future price movements are not determined by whether the next random piece of news (such as the company’s profitability or economic trend) is intrinsically *good* or *bad*, but by something far less predictable — whether the news is *better* or *worse* than anticipated. Ultimately, the price at which a stock is sold will depend on how much *another investor* is willing to pay for it (how much value he or she expects to receive from owning that security).

In conclusion, the value of a tangible asset is based on our own personal experience, so evaluating specific qualities of that unique product is important. The value of an investment depends not only on future unpredictable events, but also on how others will interpret this information. After an investment is purchased, it is out of our hands as to whether we will truly enjoy it or not. This is one of the key reasons we urge investors to forego the time and effort it takes to painstakingly research and invest in individual stock holdings. An investor’s research time is far better spent reading authors such as Larry Swedroe, Charles Ellis, John Bogle, William Bernstein and others who describe in layman’s terms how the markets as a whole function. Individual investors can best expect to capture market returns by constructing (and periodically rebalancing) a diversified, global portfolio comprised of funds that capture entire asset classes. They can then devote the rest of their research to selecting their favorite vacation destinations.

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