

TOTAL RETURN

Apocalypse Then

Lessons from the crash

LIFE TEACHES ITS LESSONS NOT DURING EASY TIMES, BUT DURING DIFFICULT ones. As distance runners say: “Every race is won or lost on the uphill.” That’s why in October my entire firm, Ariel Investments, held a firm-wide retreat to reflect on the year that had just passed. In doing so, we came away with three big takeaways.

Lesson #1**Invest in what you know.**

—Peter Lynch

When the wildly successful and now retired mutual fund manager Peter Lynch started telling people to do so in the 1980s, a completely obvious point seemed novel. Famed investor Warren Buffett makes the same case, referring to a “circle of competence.” If you understand a company or set of companies very well, that’s where you should focus your investments. In Buffett’s view, the size of the circle doesn’t matter, only that the lines are well-defined and you know what falls into your sphere of knowledge. This kind of focused expertise leads to better decision-making when stocks are irrationally high or low. If you really do the homework on the stocks you own—when the world thinks your companies are in deep trouble—you might know better and be able to buy them at fire-sale prices.

If you don’t own individual stocks, this lesson can also help you select mutual funds. You see, many professional investors don’t follow this sage advice. Rather, many diversify their portfolios across hundreds of stocks and every sector as a way to mitigate risk. Some pros even take risk avoidance to an extreme by intentionally managing their portfolios in line with the stock market indices—a practice known as “closet indexing.” These portfolios never underperform their benchmarks by much, but on the other hand it’s tough for them to beat the market by much. When you own mutual funds, I think you should stick to two groups: very low-cost index funds that match the market and highly active funds that give you a chance to beat it by a lot. Steer clear of pricey index-huggers.

Lesson #2**The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell.**

—Sir John Templeton

Even if you aren’t an active investor, you know the mantra “buy low and sell high.” But behavioral finance experts have revealed that it’s human nature to do just the opposite. People love good news, so they pile into stocks when the outlook is rosy and the upside is limited. Conversely, they run for the exits when the news is bad and the upside great.

There are two lessons here for different types of individual investors. If you’re an opportunist, instead of following the crowd, distance yourself from it. When stocks are popular and expensive, be suspect. When stocks are cheap and people are talking about how much they hate the market, be opportunistic. That’s the time to buy. On the other hand, if you are the type of person who is risk averse, protect yourself from the whims of the market with dollar-cost averaging. (See, “I’m No Fortuneteller,” Moneywise, July 2009.) The point? If you put an equal amount of money to work every so often—monthly or quarterly works well—you’ll buy more when stocks are cheap and less when they’re expensive. Plus you automatically prevent yourself from buying heavily at the top and then selling at the bottom.

**Lesson #3****The strongest of all warriors are these two—time and patience.**

—Leo Tolstoy

Let’s face it: it was very easy to get caught up in the doom and gloom of late 2008 and much of 2009. Throughout the crisis, the best way to win the war against the financial malaise was to have the patience to look beyond it. Yes, much was unprecedented—like the absence of credit. But the basic rules of investing didn’t change, and the world wasn’t coming to an end. Credit disappeared for a while, but it didn’t disappear forever. The recession wasn’t permanent. Consumers refuse to stay in a funk forever. As long as you realized that the answers were “no” in every case, you believed that the market would rise again.

Many of you might be mentally pushing back: sure, Mellody, but how did you know when the market would push back? I didn’t. Nobody did. With investing, the great thing is, you don’t have to know exactly when things will turn. You just have to have the time and the patience to wait.

—Mellody Hobson

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