Portfolio strategy: Ken Fisher

Forbe's Magazine's Portfolio Strategy columnist and Fisher Investments chief executive KEN FISHER says investors' judgement can be clouded and that after three years of downward volatility it is now time to enjoy some upside

Feel it in your bones

One reason investors can't see a big up-move ahead is the same reason they couldn't foresee the last three years – they don't see right. Ask most investors whether it is more likely an upcoming random year like 2007 is up more than 20%, up between 0% to 20% or negative? They choose 0% to 20% overwhelmingly. Flat wrong! Folks believe annual returns close to history's long-term average are more likely than extreme returns. Just the reverse is true.

Put differently, equity returns are non-normal distributions – volatile, and more so than we envisage. Consider UK returns between 0% and 20% – hugging history's long-term 10% average. They have only been in that range 40% of all years. That is, in 60% of all years returns were above 20% or negative. Elsewhere it's even more extreme. In the US, annual returns ranged between 0% and 20% in only 30% of all years – 70% of history saw returns above 20% or negative. The French? More extreme still, but you knew that: 25% versus 75%. The Netherlands and Italy? Just like the US. Other places are all somewhere in between the two great Uniteds. But everywhere normal returns are extreme. Average returns aren't normal.

We got our information processors in an evolutionary way from our ancestors, biased by tens of thousands of years of nature where annual variations really are small and normally distributed. People simply don't appreciate how volatile equities are. And always were. They don't feel it in their bones. If the FTSE's standard deviation is 25, that means if you expect future returns of 10% you think it just as likely in any year that due to normal volatility the return is -15% or +35%. If you don't feel that in your bones you also miss why most

folks couldn't foresee even part of 2000 to 2002 – they have a cognitive bias against seeing volatility, down or up, which are mirror images of the same thing. After three years of down volatility it is time to enjoy upside volatility. Here are some stocks to help.

The world's best aluminium maker is Canada's Alcan. Basic materials makers' stocks should do well in advance of the global economy mending. The market has treated these stocks like dogs. Yet Alcan grows when folks don't expect growth from it. Still, it sells at discounted valuations. Its peers on average – and its biggest peer in particular – sell at 25 times earnings while Alcan sells at only 17. It also sells at book value, 80% of annual revenue, 5.5 times cashflow and has a 2% dividend yield while you wait.

On seeing right, switch the "a" for an "o" and you get Alcon. If you can't see that clearly you need the Swiss-based global leader in eye-care with 25% of the market. Its products span drugs, surgical systems and consumer products. Whether it be eye-drops, macular degeneration, laser surgery, you name it, Alcon leads this market. As baby boomers age the market explodes and Alcon gains momentum. Formerly part of Nestlé, Alcon was spun off last year and information about it as a stock still isn't as widely disseminated as it will be.

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All of the fears about the global economy doing badly have hurt the retailers. Investors still harp on about the consumer as worn out and lacklustre. Hence opportunity. Think of the following three retailers: Dillard's Department Stores, Federated Department Stores, and Toys 'R' Us. All dominate, or at least are very strong, in their own retailing sectors. For example, Toys 'R' Us simply dominates US toy retailing, which will also benefit as baby boomers become grandparents and lavish presents on their grandchildren. These stocks sell at discounted valuations to industry averages. For example, price/earnings ratios for all these are below nine versus industry averages of 18.

For identical reasons, auto stocks are depressed – as are their vendors. Eaton Corporation is a high-quality US industrial manufacturer with heavy exposure to car and truck makers. As those markets bounce back Eaton should bounce bigger. Its product line is far broader, however, spanning electrical equipment and Eaton will also benefit from overall industrial recovery. Currently it acts, and looks, lacklustre but I bet the lustre returns. It also sells at very reasonable valuations. BM

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