LAWSON KROEKER
INVESTMENT MANAGEMENT

As We See It

"People buy stocks because they want to get rich, and they buy bonds because they don't want to be poor."

– Meir Stratman
Finance Professor
Santa Clara University
Wall Street Journal, October 21, 1997

As a general rule, investors have three objectives when investing in securities. These objectives are stability of principal, current income, and growth. Unfortunately, there is no single security which satisfies all of these objectives. Satisfaction of the three objectives requires the utilization of three types of securities or asset classes: cash equivalents, bonds, and stocks.

The portion of an investment portfolio which satisfies the stability of principal criterion consists of cash, money market funds, and high-quality, short-term (one to two year maturities) bonds. While cash equivalents offer relative price stability and income, the income generated from these securities can vary greatly as short-term interest rates change.

As the key attribute of bonds is income generation, they are used to satisfy that objective. Said income may provide for living expenses or assist in the portfolio's growth through reinvestment. Although bond prices fluctuate, the swings are usually less dramatic than those of stock prices. And bond prices sometimes rise when stocks fall. Because bonds and stocks do not always move in sync and bonds generally fluctuate less than stocks, bonds can smooth out the returns of a stock portfolio. Importantly, the income and relative stability of bonds may help investors to endure—both emotionally and financially—the inevitable stressful stock market downturns. Thus, bonds do more than satisfy the portfolio's income objective.

While stocks provide a modest contribution to a portfolio's income objective, their utilization in a portfolio is primarily for growth. Stock values fluctuate with the growth and decline of the economy, the success or failure of the particular business represented, and changes in investor psychology. However, reflecting the growth in the U. S. economy, their long-term trend has been upward providing investors with growth and inflation protection.

With the intent of reducing risk, diversification within each asset class is also important. The bonds should be of varying maturities and represent a variety of industries. The stock portion of the portfolio should be diversified, not by following a mechanical formula but by analytical selection of those companies and industries most likely to prosper.

Not only does proper diversification reduce risk, it also increases the probability, through the law of large numbers, of better returns. In any portfolio, all stocks do not rise or fall equally in a given period. Returns are often concentrated in a few issues which significantly outperform the rest of the portfolio. Since the winners are not known in advance, a diversified portfolio with its larger number of issues is more likely to have these winners than a portfolio concentrated in a few stocks.

Maintaining a balanced portfolio of stocks, bonds, and cash equivalents is a sensible way to moderate the various risks in the securities markets. Stocks make good sense for maximum long-term return and optimum protection against inflation; bonds, depending on their quality and maturity characteristics, offer varying degrees of income and principal stability; and cash reserves provide ready liquidity and the peace of mind of complete principal stability. Today's volatile conditions clearly amplify the merits of a well-diversified investment portfolio.

Year End 2000