

## **Financial Control Limited**

### **THE INVESTOR July ~ August 2002**

#### **Thought of the Month – “Case Accounting”?**

Case law is widely accepted in the legal community as a basis for establishing precedents for particular legal issues. Wouldn't it be nice if a similar mechanism existed in the accounting profession? In other words, under the current system, traders and investors must discuss important accounting issues with their auditors while the “meter” is running at anywhere from US\$200~\$500 per hour. Auditors then spend additional time researching and developing position papers on the issues that sets out their interpretation of international or other accounting standards. By this time, clients are set back a substantial amount. It seems that the Big 4 audit firms could simply post a website full of position papers searchable by topic, cleansed of client names in order to preserve confidentiality. Clients could then access these position papers and find the ones pertaining to the issue in question. Of course there could be a disclaimer at the bottom of each position paper that notifies each reader that the current interpretation of a particular accounting principle as well as its application to a particular client's circumstance could be different than that set out in the position paper. This is perfectly acceptable. Given that the Big 4 accounting firms have thousands of clients globally, chances are high that another client somewhere has encountered the exact same issue that a firm wishes to resolve. Accordingly, these position papers would serve as a great starting point for discussions and perhaps save clients substantial sums of money by already laying out most if not all of the details to consider when addressing a particular issue. The conclusions therein might in fact be the same for a particular client as well and the only task remaining would be for the client to confirm with its auditors that such conclusions applied to their particular accounting issues as well. Isn't it time we all had access to this brand of “Case Accounting”?

#### **Why is the Sky Blue? – Why should one implement a “Stop Loss Limit”?**

Perhaps the simplest answer is to cut losses. Whenever an investor enters into a new position, he or she always thinks that they are making the right decision but many times the markets prove us otherwise. The decision could even be right for a period of time but this may not last long after market conditions change or new economic data is released, reversing the original price movement. What should be done at this point, hold onto the position or liquidate? The answer should have been established even before one starts trading by setting a strategy when to exit the position, and not when the emotions take over. Therefore it is always a prudent measure to implement a stop loss strategy to either protect a portion of the accumulated profits or minimize the losses.

#### **Nourishment –The Art of Self Discipline**

In this global market downturn trillions of dollars have been wiped out and many may still be holding securities that are deep under water, waiting for the markets to turn around. There are no signs yet of volatility abating, not until all the dust has settled, and who knows what else might be in store – further corporate scandals or bankruptcies, a US economy sinking deeper, another Gulf war and escalation of tensions all around the middle east, another attack on the US, a south

American country going bust? ... and the list goes on. However this downturn could have been a blessing in disguise for some fund managers who have the flexibility of either going long or short the market, depending on the trend, their views and strategy. While some may have profited from these trends, recent market reversals were severe enough to wipe out much of the accumulated profits unless a disciplined stop loss strategy was in place.

Then you have the long-only funds where the managers do not have the same luxury in a down market and not even the facility of shorting index futures to hedge their market risk. At best they could only switch from equities to bonds or cash which would only offset some of the losses from their equity holdings. And at a more disadvantaged position are the retail investors who on average have less know-how and inside information than the professional managers. In fact most of the time they listen to these managers because they trust their advice and believe that it is wise to act upon their recommendations. Perhaps in hindsight it wasn't so wise and not exactly the right course of action. Time and time again investors were told during market dips to hold onto their long positions because the markets will come back. This advice proved correct on a number of occasions but not recently. Few had predicted the severity of this downturn and more so how long it will take for the markets to recover and reach its previous record highs. Was it the right recommendation for the average investor? Without much hesitation, many investors would say no. But with a larger proportion of the population investing their money in the stock market, perhaps it wasn't in the best interest of the asset managers to offer alternate advice as it could have dragged the markets further down. Professional advice should not be ignored altogether but investors should also supplement it with their own judgement and self discipline in order to protect their capital. Like some fund managers who employ a stop loss strategy, investors could easily adopt a similar practice where they would liquidate any position that breaches their set target limit. Had investors implemented this self-imposed rule, I'm most certain that many of them would be much happier today. On the other hand, for those with a true long-term investment horizon (e.g., twenty or thirty years), perhaps it is ok to sit back and let the markets recover over time.

### [Feedback](#)

As always, we greatly appreciate your comments and feedback. We realize that our ideas and information might be cutting edge, futuristic kind of stuff or mysterious in some ways. E-mail us anytime at [help@financialcontrollimited.com](mailto:help@financialcontrollimited.com) if you would like a) for us to clarify something, b) to recommend improvements to us, or c) to just debate with us – we like philosophy especially as it relates to financial services! Or visit our site at [www.financialcontrollimited.com](http://www.financialcontrollimited.com)

This issue was co-written and co-edited by: Robert Jones, Director and Co-Founder, FCL, and Ben Vella, Director and Co-Founder, FCL

These newsletters are designed to provoke thought and stimulate debate based on real world challenges that we face in our daily lives as we manage investments for ourselves and for others.