GREALISH
INVESTMENT COUNSELING

A goal without a plan is just a wish — Antoine de Saint-Exupéry

COMMON SENSE INVESTING

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In This Issue

"Sooner or later everyone sits down to a banquet of consequences."

Robert Louis Stevenson

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Beyond Here Be Dragons

In the Middle Ages map-making was more art than science. While local and even regional maps could be very detailed, world maps were problematic and, in any case, there were vast areas of the world that were ***Terra Incognita*** *- literally "unknown lands." Along the border that separated the known from the unknown world you might find the inscription:* ***Beyond Here Be Dragons*** *or some similar warning of the dangers and fantastic beasts that might exist just beyond the limits of our knowledge (and understanding).*

In our financial world, we crossed that border quite some time ago and we are now deeply in territory that is truly ***Terra Incognita***. Never before have the world's Central Banks embarked on such massive, prolonged, and at times, coordinated programs to flood their financial systems with credit and force interest rates effectively to zero to stimulate their economies (or stave off imminent financial crises depending on your view). While this has been a relatively common practice for a single country, it has never been done to this degree or on a global scale. We are the guinea pigs in this massive international monetary experiment. This radical government scheme policy of spending ever-greater amounts of borrowed money to solve a debt problem seems to defy both logic and accepted economic theory. Does you think it makes

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Psychology and the Stock Market

As most clients know, I have always been fascinated by the psychological aspects of investing. Over my career, this subject has grown from an intriguing footnote in graduate school Finance classes to the hugely popular field of Behavioral Finance (or its cousin Behavioral Economics). Both fields try to explain why people make such seemingly illogical decisions and continue to do so over and over again in complete disregard of results.

In grad school, my Finance professor, Meir Statman (now an expert in Behavioral Finance himself with a well-received book, *What Investors Really Want*, to prove it) introduced me to the seminal work of Amos Tversky and Daniel Kahneman who won the Nobel Prize for demonstrating that investors have strikingly different attitudes toward gains and losses. The pain of loss turns out to be at least twice as intense as the joy of a gain which factors into our decision-making. [note: Kahneman's best-selling book *Thinking Fast and Slow* is well worth reading]

So I wasn't that surprised when, after the market had advanced for a year and a half without so much as a 5% decline, I began noticing a change in attitude

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Psychology and the Stock Market

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among investors – both professional and amateur. There was growing complacency about risk especially since the riskiest assets were reaping the highest rewards. [Example: the single best performing asset for 2012 (continuing into early 2013) was Greek bonds. Imagine if someone had tried to convince you to buy Greek bonds last year when Greece was about to be kicked out of the Eurozone if it did not slide into the Aegean Sea.] Junk bonds did exceptionally well (with yields falling to all-time lows below 5%) but then so did a lot of other risky assets.

This brought up unpleasant memories of 1987, when I was still a stockbroker. In January of 1987, after a robust multi-year advance, the stock market became significantly overvalued when measured by valuation techniques that had worked exceptionally well for the previous two decades. So, naturally, I advised my clients to cut back on stocks and raise cash.

Unfortunately (for me), the market continued to rise non-stop - another 30% in nine months. As a result, in early October I had uncomfortable conversations with two clients in particular. One client was a speculator but the other was the classic low-risk investor (we called them "widows and orphans" – in fact, she was a widow). Both asked the same question: "*don't we have too much cash*?" The implications were clear – they were unhappy having missed that 30% move and I was living on borrowed time as their broker. I carefully restated why I had been worried in January and now had even greater concerns but while they accepted my explanation it was very clear that they were losing patience with me and my strategy. They weren't the only ones who called me; just the most memorable.

Black Monday came a week or two later. *The Crash of '87* caused a cumulative loss of more than 30% in just two days. Both clients called that week and both asked the same question: "*don't we have too much…stock*?"

If you think this is funny or even foolish, you should understand that these clients were expressing very normal reactions in both situations. What may look logically inconsistent was simply a major shift in their risk perception. Under similar circumstances, this is how we all would feel (yes, you too) whether we choose to admit it or not. This is why we feel like selling when prices are low and buying when prices are high even though we all know we should "buy low, sell high."

We feel better selling at the lows because we are suffering the pain caused by current losses and we want relief from anxiety over even greater losses. These are powerful emotionally-driven impulses that profoundly influence our decision-making. Logic is no match for them. Escaping the pain just seems to make so much sense. So we sell. Later on we will come up with reasons to justify our actions—to ourselves if no one else.

Why we buy at the top is less obvious. Most people attribute this to greed. "Greed and Fear drive the market" is a popular phrase. But I don't think I've ever met a truly greedy person ('though I *have* met a few who wanted more than was good for them). I think most people who buy at the top are driven more by the need to play catch-up after some missed opportunity. They may have been overly careful or even fearful and now realize that others who took the risk have reaped big rewards. Their fears have now dissipated over time leaving them wondering why they hung back in the first place – somebody must have talked them into it. So the idea that they have missed out on something that others (some less deserving than themselves) have received makes them vulnerable to throwing caution to the wind and diving in – at the worst time. So I think it is regret and the feeling that they are falling behind that makes people "buy high." It's not greed.

Which brings me to my mantra:
You have to have a plan! We cannot disconnect ourselves from our innate human nature. It will influence us whether we acknowledge the fact or not. So we need a reality check – particularly at market highs and lows – and a common sense investment plan can give that to you – provided you actually follow the plan.

Near market tops one of the various sarcastic remarks I have had tossed at me is "you're missing the boat." While I can usually ignore it, when pressed I have been known to respond "it's ok to miss the boat if its name is Titanic!"

Beyond Here Be Dragons

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sense that a government can print money indefinitely to pay debts without causing unintended negative consequences?

Which Way to Go? An investor might ask, as Alice did of Cheshire Cat, "Would you tell me, please, which way I ought to go from here?" To which the Cat replied, "That depends a great deal on where you want to get to." Alice answered "I don't much care where," whereupon the Cat responded, "Then it doesn't much matter which way you go."

Until recently where most investors wanted to go seemed to be wherever the returns were the greatest and, looking at cash flows, the riskier the investment the better. Now it looks like safety and security are more on their mind. This sea change caused apparently, by Fed Chairman Ben Bernanke *hinting* that the Federal Reserve *might* slow down ("taper" is the operative verb in the financial media) at *some* point, its massive $85 billion a month bond-buying stimulus program.

Market prognosticators and business-media talking heads immediately began producing breathless commentary on what is going to happen next and what investors should do. Follow their advice at your own risk – they are the equivalent of those ancient maps of the world.

The Truth Is: no one knows what happens next! That includes Ben Bernanke and all the other Central Bankers. We have never been here before so we cannot know what to expect.

If I had to guess, I would expect Japan to be the first casualty if only because they have been pursuing this policy the longest and have so little to show for it. Now, following their new Prime Minister's policy of "Abenomics," they have basically doubled down on those same stimulus policies that have been so ineffective. Japan has bet everything on red and the wheel is slowing.

It is easy to appreciate why the Japanese think they have no other choice – after 20 years of monetary and fiscal (i.e., government spending) stimulus, their economy and stock market have not improved. In the process the country has accumulated a crushing amount of debt. Faced with a rapidly aging population, Japan is trying desperately to inflate its way out of its debt problem and simultaneously export its way out of its trade deficit thorough currency devaluation (at its neighbors expense). So if this global stimulus policy ultimately results in disaster, it would only make sense that it begins in Japan.

Really, anything could happen. It could be (in no particularly order) Spain's banking system fracturing the Eurozone and re-igniting a European financial crisis, China's economy contracting as collapsing real estate prices overwhelms its already liquidity-challenged banking system, or maybe it will be some Black Swan event surprising us and putting all rosy scenarios to the test.

Which are only a few reasons why I continue to believe that the best single strategy is the one proposed in the *Special Strategy Issue* of last November: ***Hope for the Best, Prepare for the Worst!*** In markets like last week, it's far more important to be a survivor than to be a hero.

What to do: (a) Follow your investment plan (If you don't have a plan, get one!); (b) don't take more risk than you can handle (financially and psychologically) regardless of the potential reward; (c) keep cash on hand – cash is no longer "trash;" (d) stick with your plan's bond allocation but consider raising quality and lowering duration; (e) ignore the short-term ups and downs of the stock and bond markets along with the manic-depressive commentary on CNBC; and most importantly (f) if you are worried – call me and we'll talk about it. ▯

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The End of the Bond Market (or is it?)

In my opinion (to paraphrase Mark Twain), *the reports of the death of the bond market have been greatly exaggerated.* My philosophy about bonds (also noted in the November special newsletter) has been that we need to be in bonds for diversification, income and stability (to dampen portfolio volatility)…but we need to be nervous about it. The past six weeks (last week in particular) demonstrated why nervousness is called for. But despite the damage, I very much doubt that this marks the end of The Great Bond Bull Market (it might be, however, in Churchill's words, "the end of the beginning").

So what's new? The normal causes of higher interest rates, inflation and robust economic growth, are hardly a credible threat right now. The major buyer of bonds, the Fed, did not say it stopped buying bonds, only that it is considering slowing down its buying program at some point in the future – possibly this year. This is not news. Only the most ardent of Fed devotees expected that this could go on forever. What's new is that Ben Bernanke publicly stated the obvious.

It is also <u>not</u> news that the "hot money" has been waiting for a signal to sell bonds and as with any good panic in a confined space, you want to be the first one out the door. In spite of the well-known and consistently proven trading rule that "nobody rings a bell at the top of the market" a number of bond traders seem to have mistaken Ben Bernanke for Quasimodo, the hunchbacked bell ringer of Notre Dame, and sprinted for the exit at this first hint of Fed policy change.

Which is why it seems to me that last week's bond sell-off was more of a panic or a liquidity-driven event than a major market reversal. It seemed to be all sellers and no buyers. Just about everything sold off which usually means a financial crisis (as China seems to be experiencing) or a self-reinforcing trader stampede than it does the beginning of a new trend. But then, I could be wrong.

It is worthwhile to remember that bonds are still safer than stocks. I should also point out that US bonds are safer than European or Japanese bonds and *particularly* safer than the bonds of emerging or developing countries. If the last few weeks are any indication, they are also relatively safer than the dividend stocks, MLPs, and laundry list of "alternative investments" that have been widely touted as bond substitutes.

Don't get me wrong. We should continue to be nervous about bonds (just as we should be nervous about stocks, real estate and the state of the economy). We should relentlessly question our strategy if for no other reason than to keep from becoming complacent about risk or believing that we actually know what will happen next. Our investment strategy should have prepared us for the (inevitable) rise in interest rates. If it didn't, it is getting pretty late in the game to have to come up with a reasonable alternative ▯

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