

"If a man gives no thought about what is distant, he will find sorrow near at hand."
– Confucius (551 B.C. – 479 B.C.)

February 2012: Staying Focused in a Distracting World
By John Goltermann, CFA, CPA

Part I: Investors' (Including Our) Biggest Mistakes

In the pursuit of earning investment returns, one has to deal with the impact of other people's actions – actions that are primarily driven by thoughts, emotions and preferences. This complicates the pursuit greatly. On any given day, an investment's price reflects the preference of others to hold or not hold it. Sometimes these preferences are related to an investment's long-term value/risk proposition; sometimes they are not.

To understand investment markets is to understand what motivates human beings. Not that humans are ever truly understandable, but there are certain constants that can be relied upon to provide ongoing sources of risks and opportunities. For one, people's perceptions are inevitably anchored by the past because the past is readily observable. On the other hand, the future is *not* observable and involves guesswork. Other constants include the desire to survive, to seek status and to protect and improve one's family's standard of living. To this end, people tend to take action based on how they *feel*, which is partly learned and partly imprinted from birth, and not on what they *think*. This is the continual struggle of human existence.

If one reflects upon the pricing action of various assets relative to changes in fundamentals or the values of businesses, they are sometimes almost totally disconnected. Price movements are almost entirely due to behavioral and incentive-based influences in the short run. For example, in 2011, the market price of many businesses declined 30% to 50% without any accompanying change in the long-term terminal value of the businesses or their asset bases' cash-generating power – or even in the actual performance of the businesses. With the threat of a slowing in the global economy, the market prices of businesses more closely tied to global growth were driven down to levels that implied that their profitability was about to go to zero, that their profitability would never recover and that their assets would all be sold at auction.

The stocks of many of these cyclical businesses were purged out of portfolios *en masse* because of fears relating to Europe, slowing growth in China and domestic political dysfunction. Selling was fueled by reactions to incentives, perceptions and *feelings*. Of course, different kinds of market participants take actions for different reasons, but the following are two factors that are relative constants:

1) Institutional investors don't want to get fired (or be downgraded by the consultants who recommend them). Many are subject to severe scrutiny and a probationary period if they hold poorly performing positions over a very short time frame. Hence, they have an incentive to never *look* wrong and their decisions are often made under the assumption that it is always better to be wrong with the crowd (which is forgivable) than to be wrong on a contrarian, controversial, unconventional or outlier view. If a contrarian view doesn't work out, by definition *it was obvious that it wouldn't work in the first place*, so there is no incentive to have one.

2) Individual investors don't generally have the patience to stick out challenging situations and constantly move money around to things that are "working." This is the fatal flaw of many investors and is a process akin to driving up Independence Pass looking only in the rear view mirror!

The problem is that these two factors are usually counterproductive to earning returns which, after all, is the goal of investing. So with that primer, a discussion of some of the biggest mistakes that investors (including us) make follows here:

Mistake 1: Recency Bias – When looking at the past, investors place more importance on recent events rather than on those of the more distant past

Recent events are more recallable and visceral. One has to look no further than capital flows to mutual funds. Funds with strong recent performance attract large inflows because there is a belief that those managers are "on a roll" and will *continue* to be "on a roll." This is called the "hot-hand theory." Research shows over and over that the hot-hand is only an illusion, a trick that the brain plays on us. If you look at professional basketball players, the hot-hand is only known about *after-the-fact*. As the table below shows, the number of shots a player hits in a row *has a negative correlation* to the probability of him hitting the next shot. In other words, if the player makes three in a row, the odds that he will hit the fourth shot are actually *lower* than if the player missed three in a row.

Probability of Making a Shot Conditioned on the Outcome of Previous Shots for Member of the 76ers

Player	P(x 000)	P(x 00)	P(x 0)	P(x)	P(x x)	P(x xx)	P(x xxx)	r
C. Richardson	.50	.47	.56	.50	.49	.50	.48	-.02
J. Erving	.52	.51	.51	.52	.53	.52	.48	.02
L. Hollins	.50	.49	.46	.46	.46	.46	.32	.00
M. Cheeks	.77	.60	.60	.56	.55	.54	.59	-.04
C. Jones	.50	.48	.47	.47	.45	.43	.27	-.02
A. Toney	.52	.53	.51	.46	.43	.40	.34	-.08
B. Jones	.61	.58	.58	.54	.53	.47	.53	-.05
S. Mix	.70	.56	.52	.52	.51	.48	.36	-.02
D. Dawkins	.88	.73	.71	.62	.57	.58	.51	-.14
Mean =	.56	.53	.54	.52	.51	.50	.46	-.04

Note: x = a hit; 0 = a miss. r = the correlation between the outcomes of consecutive shots
 Gilovich, Vallone, Tversky 1985

Ironically, investors behave with the opposite belief. While investing is not the same as making basketball shots, the statistics are similar. Strong performance by investment managers in one period does not predict subsequent outperformance *or* underperformance. But investors act as though it *does* predict outperformance because of how it *feels* to pass the ball to the hot-hand. This is confirmed by money flows to funds with strong relative performance. Investors don't move money based on a manager's returns earned six years ago.

Mistake 2: Overconfidence – Those who *feel* confident about an idea or investment tend to trade the most

Those who trade the most frequently have the worst results. It's not because of transaction costs, but rather because of their consistent reaction to the pricing feedback that gave them their confidence in the first place (generally past performance or price movements, or something somebody wrote that seemingly confirmed whatever they believed) and because of mean reversion. In other words, by the time the feeling is formed, it's too late to act in a profitable/constructive way.

Mistake 3: Confusing great companies with high future investment returns

Data show that the market knows about *and prices in* high future profit growth before it actually occurs, but that this projected profit growth is priced too optimistically. In my strong opinion, markets price risk, not growth. In fact, research from Grantham, Mayo and Van Otterloo shows that there is a negative correlation between high profit growth and future returns (high profit growth predicts slowing profit growth). Of course, this is not an absolute, but the market is chock full of cautionary tales on this – think back to Cisco, Microsoft, Hewlett Packard, Intel, most financials and many other high-growth companies.

Mistake 4: Putting too much weight on the importance of comparable metrics such as P/E (price-to-earnings) ratios

Earnings results can be easily gamed by managements and can be volatile for reasons having nothing to do with the execution of the business or the business' future opportunity set. Even if you normalize earnings and try to infer information from these figures, they only function like a point spread in sports. They just tell you what other people think. And like a point spread, they have nothing to do with what makes for a good bet or a bad bet, nor do they predict future outcomes in any way.

Mistake 5: Listening to experts

The future is not forecastable by anybody, but everybody has guesses. TV and print media give credibility to pundits and writers when there isn't necessarily any. With investment markets, it's best to listen to people who talk about what assumptions are priced in, not what is likely to happen in the future.

What we can learn from these mistakes

To us, investing is the process of assessing the *degree* to which a risk (presented by an investment) is reflected in the current price – and allocating capital to opportunities where we are being well-compensated for taking each risk. Our goal is to construct a portfolio of *well-*

compensated risks. By this we are referring to the potential payoff relative to risk (of course the analytics of this are imperfect, as are the data that go into the analytics).

The compensation level that certain risks offer has nothing to do with their ultimate outcomes, especially over shorter periods of time, but we attempt to continually assess whether potential upside for each position still exists. While we certainly don't consider investing to be gambling or investments to be bets, there *are* certain parallels.

Investing is similar to horse racing or any other pari-mutuel activity. Think of the odds on a horse in a race as its *price*. Let's say the horse pays 30-1, but through research (history, strength, track conditions, weather, jockey *and other horses* in the field) you determine that the realistic probability of its winning is 20-1. In this case, the horse is underpriced and you are compensated to take that risk. Odds are set by the level of capital (wagers) that comes in, and 30-1 horses are priced this way because very little capital (few wagers) is being placed on it. An underpriced opportunity does not guarantee that you will win that bet, but you are compensated for taking it. The relationship between the price and the actual odds of a favorable outcome is what matters. If you have a portfolio of all 7-6 horses and the actual odds of winning each one are around 50-50, you'll have more "wins" but lower long-term returns than you would if you had held more of those where the *amount* of the mispricing was greater – *irrespective of the actual odds*.

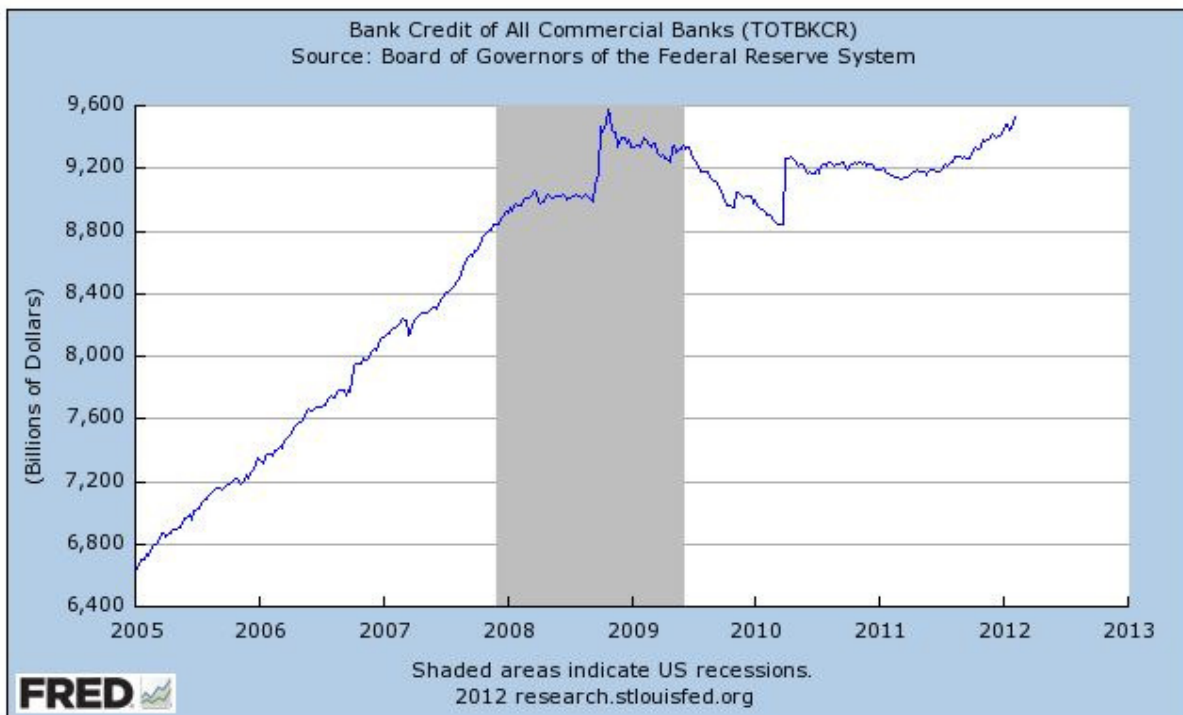
Part 2: What All Investors Currently Are Up Against

Besides overcoming our DNA (or at least mitigating its impact through a disciplined investment process), everyone has to grapple with the same investment backdrop. Admittedly, in our commentary we harp on the investment backdrop month-in and month-out, but the *real* issues in today's world are the combination of excessive debt and promises by U.S. and European governments, and the continuous monetary expansion by central banks.

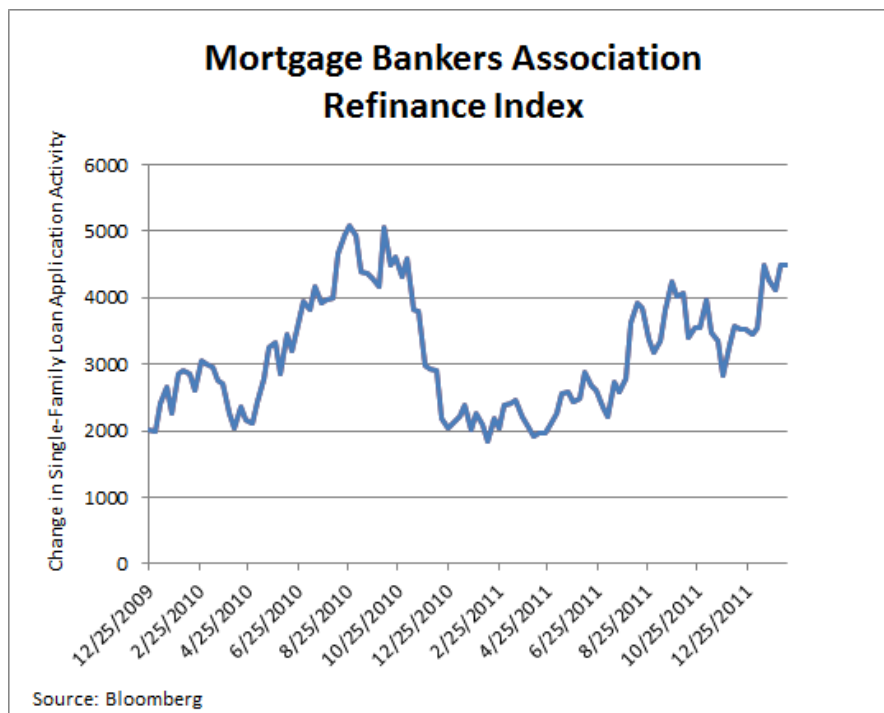
The stock market has rallied strongly in the first six weeks of 2012 amidst skepticism and widespread caution. A very cautious sentiment is typical of the early stages of a bull market, and we are pleased with the nervousness because it implies a lot of investors are still reluctant to put money out for long-term gain (one needs to look no further than 30-year bonds at 3.00% for confirmation of this). Of course, bull markets are not smooth and are frequently punctuated by violent corrections.

We are aware that many of our readers may be wondering how a bull market can continue with such poor economic conditions in the U.S. and Europe. After all, private-sector debt continues to flatline, unemployment is high, foreclosures continue unabated and, as we've written about previously, the very structure of the Eurozone itself is severely flawed. While these are all true, it is important to realize that when it comes to investing, monetary policy generally trumps these other factors. In other words, when interest rates are low and money is cheap, asset prices rise over time.

At the moment, interest rates are extremely low in most nations, and central banks are pushing liquidity into the markets. Credit transmission is still very slow due to the combination of new regulations and the drag on banks from their legacy assets (unrealized losses) that have yet to be purged. But there are some encouraging signs, as indicated by the chart below which reflects a pickup in private sector bank lending since the beginning of 2011.

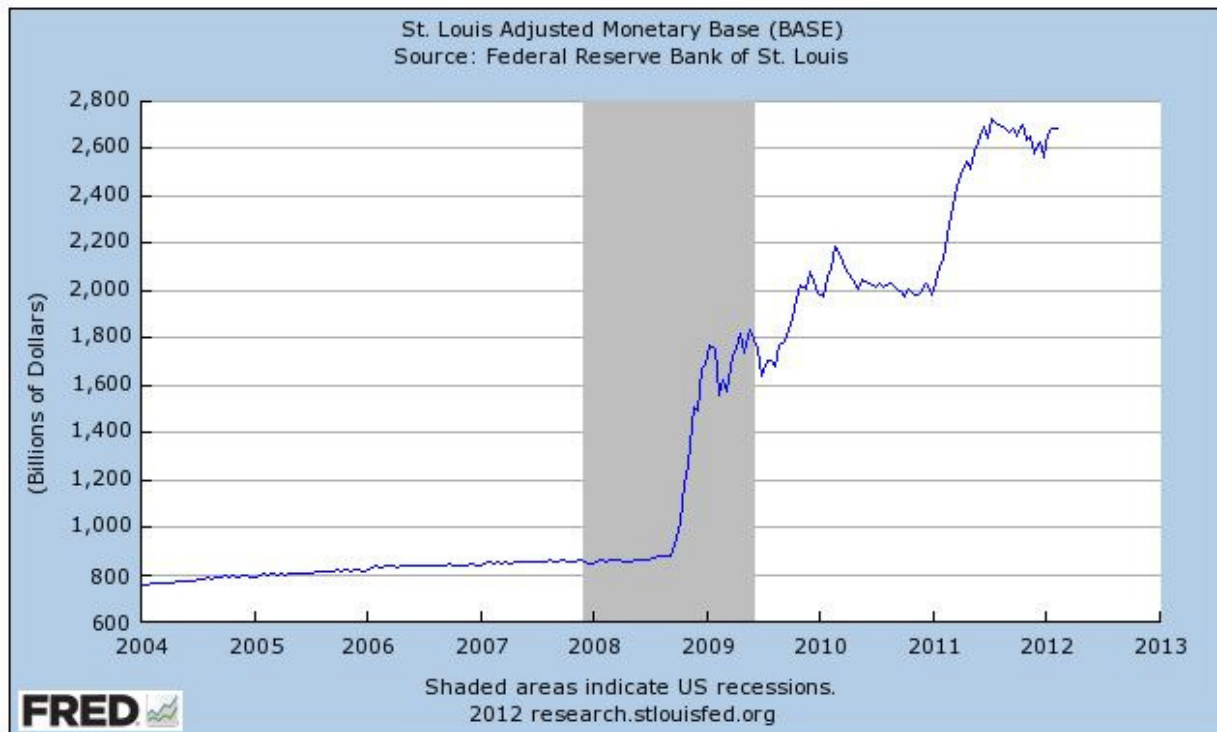


Refinancings have also picked up lately, indicating that the velocity of money is beginning to pick up as well.



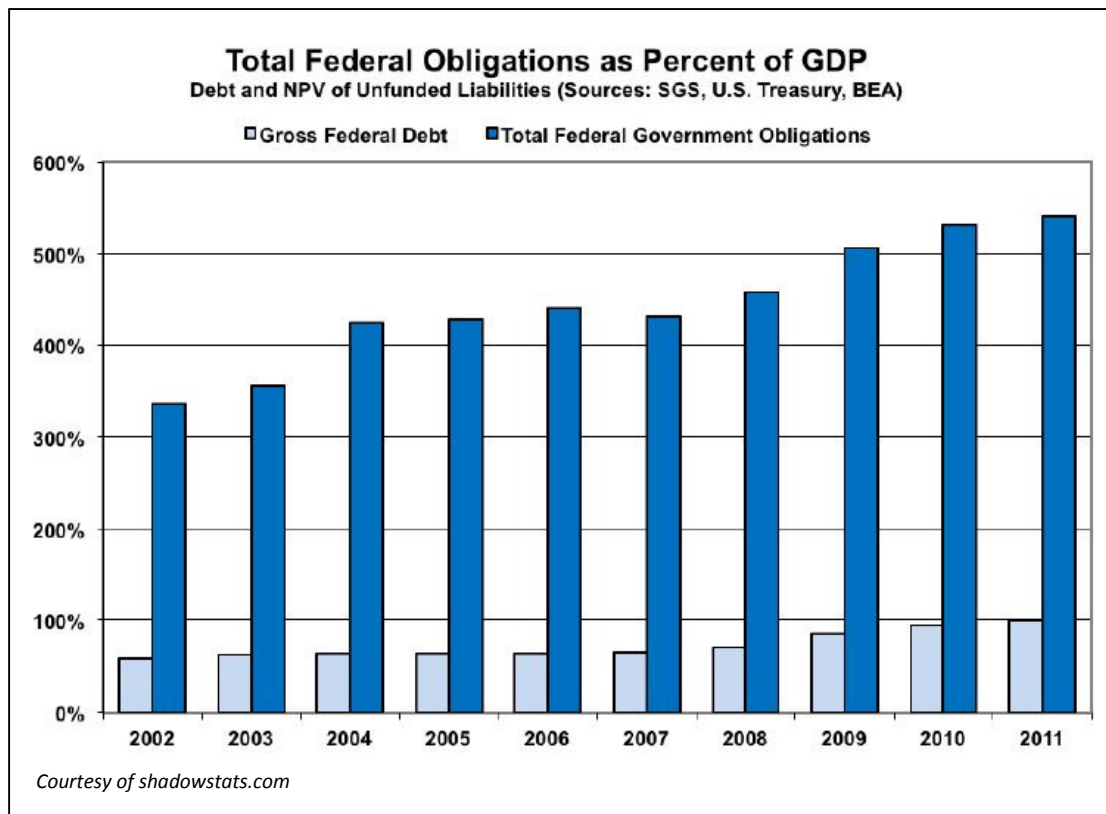
The Federal Reserve is doing its part to encourage lending (apart from manipulating rates) by increasing the adjusted monetary base, which is essentially the amount of currency in circulation plus commercial bank deposits held at the Fed. The expansion of the adjusted monetary base helps prop up asset prices, but more importantly (to the Fed) it buys the banks

time to write down their bad assets in an orderly way. The chart below shows the massive expansion in the monetary base since the financial crisis, which underscores the Fed's dogged determination to push dollar liquidity into the system. The Fed, however, is running the risk that much of the liquidity could drive up the cost of living at an even faster rate in the future. In essence, this is an inflationary monetary policy that benefits speculators and crushes savers and the volatility-averse.



The first step toward addressing a problem is admitting it exists. Our fear is that investors who are not willing to accept portfolio volatility will end up losing their living standard as the purchasing power of their savings declines inexorably and cannot be recouped in bonds or bank deposits. This would represent a *permanent* loss of real wealth for those folks who value low volatility over an appropriate strategy to mitigate dollar debasement.

While the developments indicated above are all well and good for stock and commodity investors, it is important to understand that – rather than let the system clean itself out – U.S. policymakers have decided that it is better to defer any cleansing process or pain by borrowing huge amounts from the future, thereby papering over the terrible decisions made by themselves and their powerful Wall Street allies. Since the financial crisis of 2008, government debt has expanded (on an accrual basis) by \$10 - \$15 trillion, depending upon assumptions.

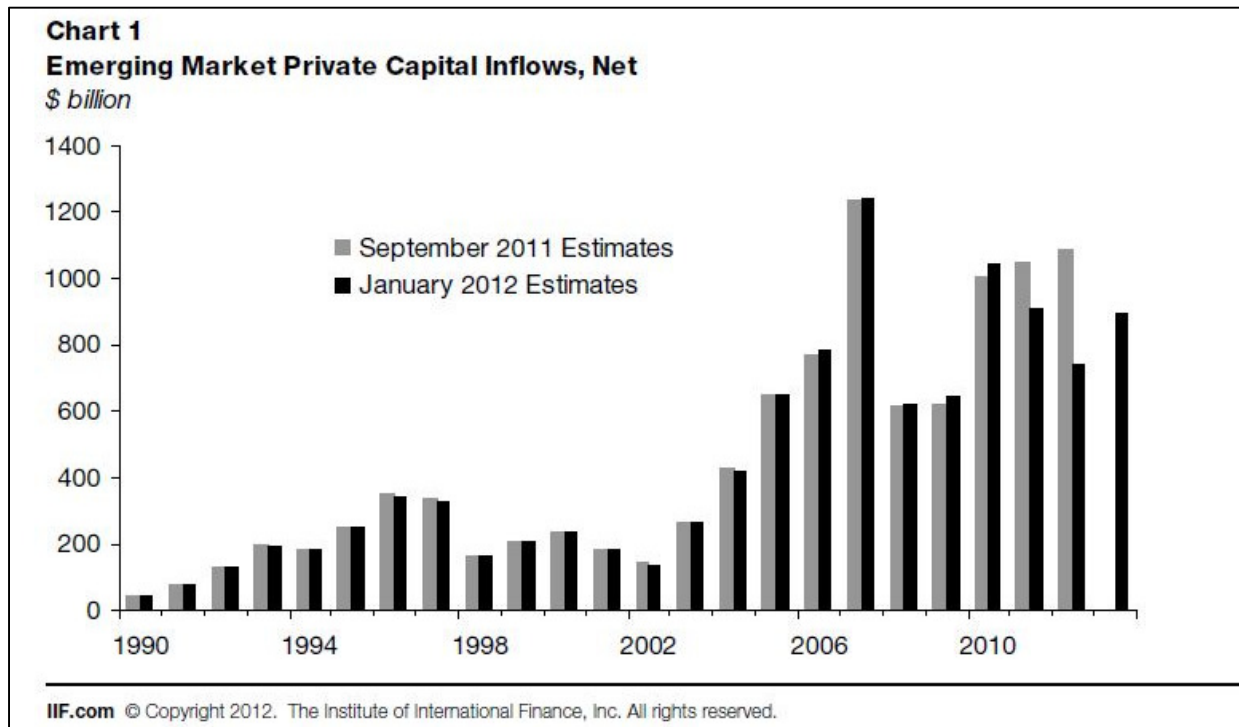


The harsh reality is that this debt expansion cannot be funded by tax revenues. It can only be funded by debasing the dollar (through inflation), which is indeed the strategy that the Federal Reserve has embarked upon, as evidenced by the expansion in the adjusted monetary base. The artificial repression of interest rates (to stimulate the economy) is also a negative for tax revenues because low rates suppress taxable interest income. In effect, the government has chosen to finance its continued expansion mostly by rolling over its existing debt (and issuing new debt at suppressed rates) instead of through taxes on interest income.

This inflationary policy is much more of a negative for bond investors than it is for equity and commodity investors *in the long run*, though that is certainly not what markets told us in 2011. By borrowing huge amounts of money from the future to prop up the present, the government has distributed the cost of private sector risk-taking to an unsuspecting public, and it will likely be earned back by paying the lenders in cheaper dollars. The losses that occurred from poor banking policies and excessive credit expansion (that were incentivized by Fed policy in the first place) are very real; by transferring them to the U.S. Treasury, they have been passed on to American citizens.

Given the government's recent inflationary efforts, we have no doubt that the intent is to reignite another debt cycle to promote the illusion of prosperity. In our view, this is a very risky policy that may very well undermine foreigners' confidence in U.S. government debt. This is why we believe that the ongoing price increases in stocks and commodities will not end anytime soon (the path will not be in a straight line of course), and it is also the reason that we recommend minimizing exposure to cash, CDs, longer term bonds and other fixed income assets (except for near term needs) for those who can tolerate some volatility.

We are also persuaded by evidence that much of the U.S. and Europe will continue to struggle economically for a long time. The combination of declining demography and deleveraging will be big headwinds for *real* economic growth. Accordingly, stock markets in the developed world are likely to underperform those of developing nations over the long run (in real terms). Similar to Japan, which experienced a long period of deleveraging and an aging demographic, the U.S. could begin to see much of its private investment move offshore in search of higher returns, higher rates and stronger currencies, and to participate in financing faster growth and increasing productivity.



To be certain, as the world shifts, many U.S.-based businesses will continue to do well and their profitability will increase, but we expect *relative* economic growth to continue to be higher in the emerging markets.

A Word on Inflation

There seems to be much confusion on inflation. Inflation is *not* a general rise in the overall price level, as many mistakenly believe. Indeed, the press incorrectly promotes this idea, and reports the Consumer Price Index (CPI) and Personal Consumption Expenditures (PCE) as indicators of whether inflation is here or not. They also promote the idea that rising prices are just kind of happenstance, that they can't be tied back to policies or structural imbalances.

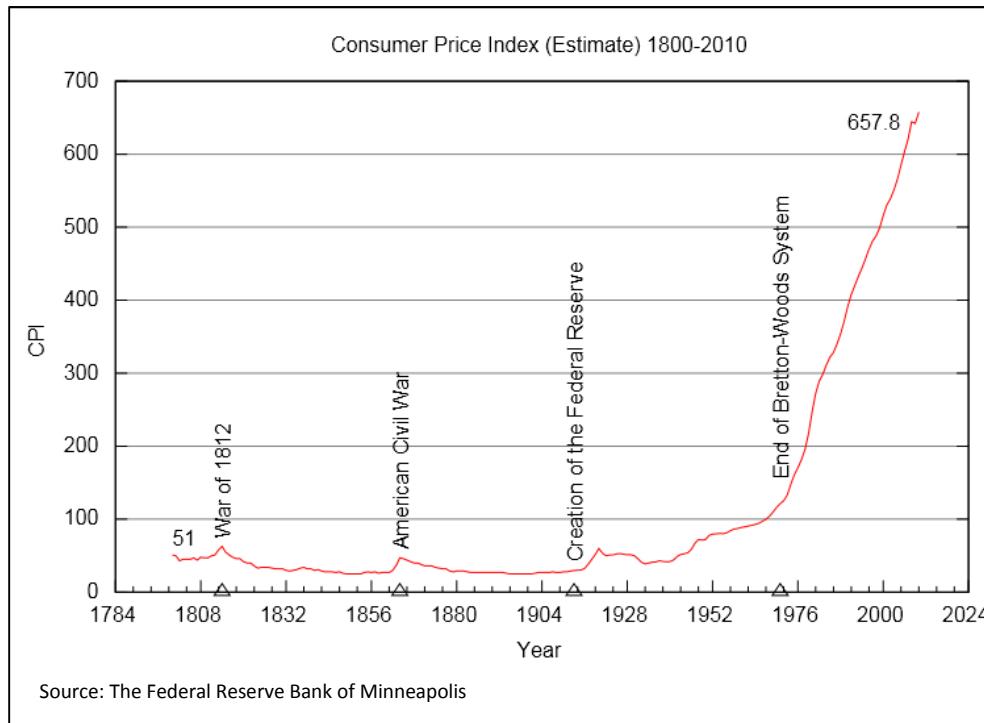
The definition of inflation is *an expansion in the quantity of money and credit within an economy*. As noted in the section above, *inflation is already here* as a function of the increase in commercial-sector bank lending and the adjusted monetary base. Rising prices are merely a *symptom* of inflation.

Contrary to what we are told, tremendous economic progress can be made without inflation. If you look at the 19th-century technological developments – the steam locomotive, telegraph and

telephone, light bulb and photographs – you’ll see that the economy did very well without continually trying to devalue the dollar to “stimulate” exports. All of this happened under a gold standard where the dollar was relatively stable in terms of purchasing power.

Policies that promote inflation can be destructive to average citizens because inflation tends to disproportionately benefit the political and financial elite – and overly punish the risk-averse and those citizens who live on a fixed income. Although inflation can also benefit those in goods-producing businesses and those who are prepared for it, for most people it is an insidious form of taxation and the easiest way for governments to confiscate the public’s savings. There is also a geopolitical motivation as devaluing one’s currency “transfers” prosperity from trading partners (for a comprehensive overview on this I suggest the book *Currency Wars* by James Rickards).

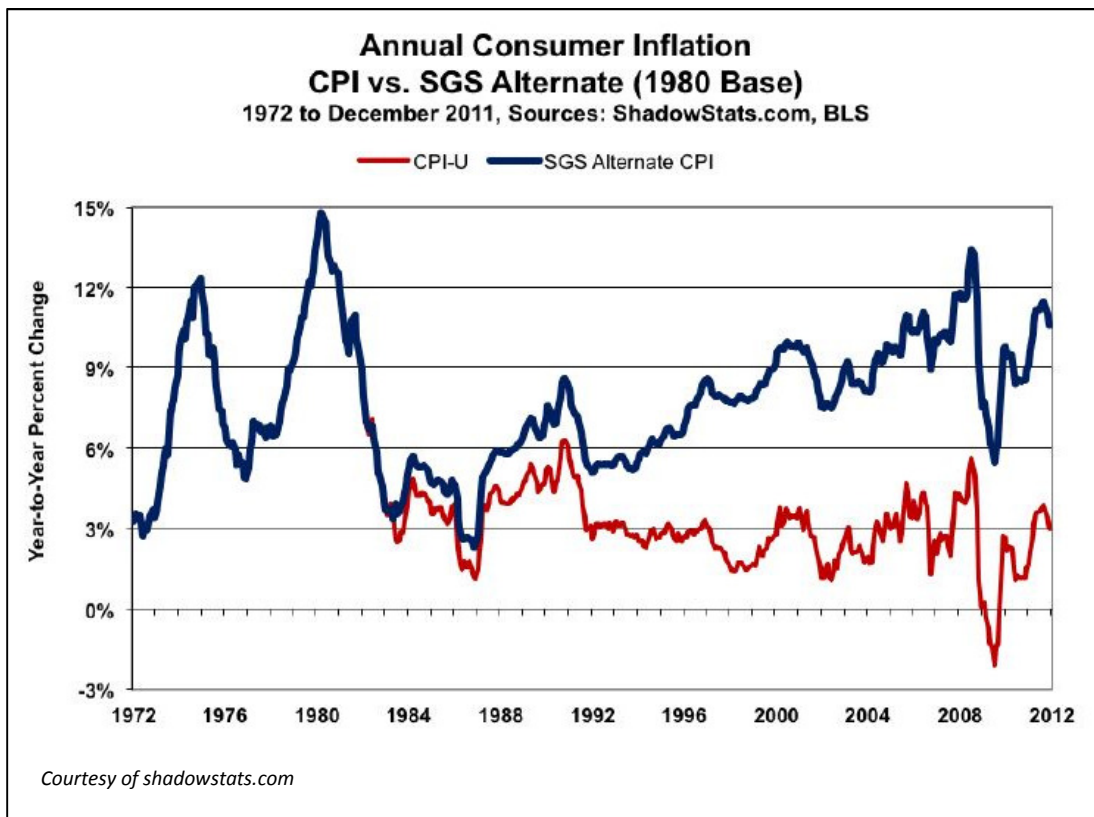
Money is supposed to be a stable store of value, and indeed it was for most of U.S. history – until, that is, Nixon removed the U.S. dollar from the gold standard in 1971. This is when things began to change. In my view, it is our government’s policy to continuously debase the dollar through continued reckless central bank stimulus; the dollar no longer fills the critical role of a stable currency in the long run.



This may also have something to do with why many people never seem to be satisfied with what they have accumulated through their efforts, labor and risk-taking. They have no idea what their savings or their investment portfolio will buy them in ten or twenty years’ time! So rather than enjoy their lives, many people continue with their endless pursuit of acquiring more money, which is a rational response to the inexorable decline in the purchasing power of dollars. Unfortunately, few connect the dots back to monetary policy itself, so central banks and governments continue to get a free pass on the destruction they create.

In order to ensure the continual flow of benefits to Wall Street and the political elite, there is a deliberate misguidance that an expansion in the supply of money and credit is *not* inflation. Rather, the public is sold the idea that the consequence of inflation (rising prices) is in fact inflation. Within an economy, prices do not rise on their own. An ear of corn is an ear of corn. What changes is the purchasing power of the money that is used to buy corn. The decline in that purchasing power is an asset-based tax.

Furthermore, the establishment does everything in its power to suppress the widely embraced measurements of the general rise in prices: the Consumer Price Index and the Producer Price Index. Government agencies shamelessly doctor the CPI and PPI calculations by various seasonal, hedonic and weighting adjustments. The chart below shows the discrepancy between CPI-U as published by the Bureau of Labor Statistics and the SGS (Shadow Government Statistics). Alternate CPI, uses the calculation methodology that was in place before 1980 (before the Bureau of Labor Statistics changed its methodology). Over the past 20 years, prices have been rising much faster than acknowledged. Many are in tune with this and are rightly suspicious of the official numbers. Here is the data:



Inflation is doubly harmful to retirees since they are no longer able to earn more money in order to maintain their standard of living. Thanks to inflation, many senior citizens are at risk of outliving their money. To put their nest egg into savings, CDs and Treasury bonds is to trust the government and its central bank not to devalue it. In my opinion, this is a bad bet given current policy actions and motivations.

What to Do About It

Dollars are now used as a political tool to absolve politicians from responsibility in promoting sound economic policies and running balanced fiscal books. Those who do not recognize this and take action to offset its effects in their investment strategy will likely suffer a declining standard of living. To offset this, a sensible portfolio with long-term positions and enduring tolerance for some volatility is required. Precious metals, stocks of commodity producers and certain foreign currency bonds are also a must as they will be the mostly likely assets to keep their real value in the long run. Prices of these will undoubtedly whip around all over the place over time as pulses of deleveraging and risk-aversion come and go, but the effect and risk of central bank policy is the same.

There will be periods where capital will flow in unpredictable ways. Gold, oil, foreign stocks and bonds may frequently underperform (over shorter periods) as people who embrace traditional views of risk (to avoid volatility) move to the perceived safety of bank deposits and Treasuries. Bank deposits and Treasuries are indeed low-volatility instruments, but they are not low risk – *there is a difference.*

We feel that large, stable, strong, global companies that produce things that people need, that improve their status and provide overall well-being have a big place in investment portfolios. Moreover, demographic trends and changes in the regulatory environment call for a certain amount of health care investment. Companies that benefit from people looking to save money or save time are also likely to do well over time. Apart from that, we expect resources in the ground (especially those in energy), in politically secure areas to rise in value as production costs continue to rise and as cheap oil is depleted.

On behalf of our clients, it's important for us to stay informed, stay flexible and stay vigilant. We want to maintain high-quality positions and ride out volatility. We continuously check in with what's happening with portfolio companies, but also recognize that price movements usually do not represent changes in fundamentals – it is usually just a change in preferences and people acting on those incentives discussed above.

The major risk for society is an increased cost of living. The combination of the rise of the emerging market, scarcities and the expansion of cash and credit emanating from the Fed could bring a more rapid increase. As a result, we would not be surprised to see a shift in mindset from people wanting to protect from volatility to wanting to protect from the rising cost of living, which could create a spiraling, self-reinforcing feedback loop of new liquidity mostly going to food, energy and metals, driving up prices at the expense of those who continue to avoid portfolio volatility. We strive to hedge this risk in a prudent way.

DISCLOSURE: Past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be suitable for an existing or prospective client's investment portfolio. Therefore, no existing or prospective client should assume that future performance of any specific investment or investment strategy (including the investments or investment strategies recommended herein) will be profitable or equal any historical performance levels. Certain portions of our newsletter may contain discussions of recommendations as of a specific prior date. Due to various factors, including changing market conditions, such discussions may no longer be reflective of current positions or recommendations. Information included herein should not be construed as the receipt of, or a substitute for, personalized individual advice. A copy of our current written disclosure statement discussing our business operations, services, and fees is available upon written request.