

September 2010: A Perspective on “Belief” Systems and Markets

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The photograph below, which was taken in the 1920s, has sat on my desk for years. These are bicycle racers in the Tour de France getting ready for a big hill climb and they are smoking cigarettes because it was believed, at the time, that cigarettes helped improve respiration. I have this picture to remind me that what we *know to be true* often turns out to be untrue.



It is important to me to remember this concept because if we look back through the history of financial markets, it is littered with the wreckage of ‘beliefs’ that were *too* widely held. It is the markets’ function to ultimately purge ideas that are built on shaky foundations. If we are aware of this when forming our investment strategy and in choosing individual investments, it will promote a healthy level of skepticism towards *en vogue* investments and more interest in those that are unpopular – a necessary practice for long-term investors.

This is not to condone being a *pure* contrarian because sometimes the crowd *is* right, but skepticism is an attitude that should be applied to any new investment opportunity. It is

important to ask the question “*what assumptions are others making about this investment and will they hold true in the future?*”

When I refer to ‘beliefs’, I’m not speaking of religious beliefs, or political beliefs, or even economic beliefs; instead, I am referring specifically to belief systems as they relate to asset markets and investments which are eagerly embraced by the public at large.

Belief systems in asset markets are generally formed based on theories that use backward-looking data. They are validated by things we can readily observe and by discussions and agreement around common experiences. They have to do with incentives and the way human beings are wired. We have to remember that at one point people almost universally agreed that the earth was both the center of the universe and was flat – to suggest otherwise was heretical.

But in investment markets, we can see a similar pattern because the emotions and behavioral factors that drive the movement of capital are extremely powerful. We can go all the way back to the Dutch Tulip Mania or South Seas Company in the 1600s and 1700s to see how beliefs are formed and purged. Sometimes they create bubbles, and at other times some assets or sectors become so widely reviled that they are sold down to levels that don’t make sense. Below are some examples of widely held beliefs that tripped up investors in more recent history:

- 1) Late 60s/early 70s: the assumed infallibility of the Nifty Fifty stocks, which were large companies characterized by stable earnings and dividends. There was a belief that these were “one decision” stocks that could be bought and held, irrespective of price
- 2) Mid-to-late 70s: the assumption that commodity prices would increase forever because inflation was here to stay
- 3) Late 70s: the belief that bonds were “certificates of confiscation” and to be strongly avoided
- 4) Early 80s: belief that one either had to be crazy or masochistic to buy stocks
- 5) Late 80s: the idea that Japan was going to dominate world GDP because of superior technology and supply chain management systems
- 6) Mid-to-late 90s: the belief that technology had created a New Economy and that everyone who invested in tech stocks (or went to work for a tech company) would be able to retire in 5 years
- 7) Early-to-mid 2000s: the belief that bank stocks are always good investments
- 8) Mid-to late 2000s: the belief that real estate won’t go down because they’re “not making any more of it” and it hasn’t gone down since World War II

The common thread binding these themes is that they were *too widely embraced*. But this is only clear in hindsight. At the time, there was a strong consensus and good data to support the investment case for each one. But if investors had asked themselves under what conditions would *these beliefs continue into the future*, they might not have been exposed to the pain involved or the opportunity cost of the markets’ ultimately proving them untrue.

Now, as always, there are beliefs still at play that may yet be purged by markets. These beliefs can be observed in the assumptions underlying statements made by some TV pundits and investment advisers:

- 1) Cash and U.S. Treasury bonds are safe
- 2) Gold is always a terrible investment and is obviously in a bubble
- 3) Crude oil is wonderfully abundant and its price is based mostly on economic growth and demand in the U.S., which is the driver of the world
- 4) Emerging markets carry excessive risk
- 5) The dollar will always be the reserve currency of the world
- 6) Deficits don't matter and governments should intervene to offset financial pain dispensed by markets
- 7) Inflation can't happen in the U.S. because the deflationary pressure from real estate and bad credit is too great

Policy decisions being made by the government today are geared toward attempting to assuage the pain felt by the economic damage that resulted from excessive speculation and grossly misallocated capital (that resulted from government policies and artificial incentives in the first place). Macroeconomic policy is at the top of governments' agendas around the world. There are very few (at least very few in positions of power) who believe that if we let markets do their job, we allow recessions to occur and we clear the system of bad investments, bad loans and bad ideas, that we will end up better off.

Instead, markets' attempts to purge bad investments are met with a big-time government effort to countervail them – and the cost of this response is being charged to future taxpayers in the form of increased government borrowing (bond issuance), the politicization of accounting standards, and ever-increasing needs for subsidies. Our fear is that the current policy responses may simply defer and transform the pain (that probably needs to be experienced) into a possible future U.S. sovereign credit or currency crisis, which could manifest itself through a nasty inflation. If this is the case, today's beliefs (enumerated above) will also be purged by markets. While we can't be sure of this, as advocates for our clients, we would like to be prepared.

Our skepticism of the current beliefs are expressed in our equity and fixed income positions. While we won't get everything perfectly right, our goal over the long-run is to build real wealth protection superior to those who unquestioningly follow what they "know" to be true.

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