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THE INVESTOR'S MIND:

ANTICIPATING TRENDS THROUGH THE LENS OF HISTORY

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LOSERS: WHY WE INVEST WITH THEM

One thing that didn't change much after the 2000 to 2002 decline is the misperception that, when selecting investment managers, the most important thing to look for is how they did last quarter or last year. It's an obsession that never seems to change much. But then again, in today's culture, why should it change? The advantages of capitalism have, unfortunately, led us to consumerism and the belief that we can get anything, at any price, at any time. With the advent of the internet, easy credit, and the sense of entitlement our prosperity as a nation has fostered, many have come to believe that they can have it all and they can have it all, right now.

It is not my intention to debate whether this has served us well as a nation. What I do know is that this mentality does not serve the investor and, as such, must be discarded before we can attain to any lasting success. As evidence to this fact, I offer the stories of some of our investment icons in days when they may not have been so warmly embraced.

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- **Buffet, GMO, Dunn, and Biggs**
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A TRIP DOWN MEMORY LANE

Think back, if you will, to 1974. If we put ourselves in that era, it's been just 3 years since the dollar was removed from the gold-exchange standard, and our national debt has already topped $474 billion. [1] The Arab Oil Embargo is in full swing and Americans are waiting in long lines for gas as prices continue to rise. Plans for busing black children to white schools in Boston, has set off a series of race riots. Under intense public and Congressional pressures, Richard Nixon has become the first President of the United States to resign.

The Dow has lost 45 percent, falling from 1051, in January of 1973, to 577, in December of 1974. Fund managers, who had been eager to buy just a few years earlier, have now taken a "batten down the hatches" approach to the markets. Consider the words of Eric T. Miller, a manager at Oppenheimer at the time.

> "I wish we could say that we have strong preferences for areas that are unique right now, but we don't, partly because we don't think it's time to try to be a hero… to be terribly venturesome, unless you could put me on [an] island and we were taking a three-year view." [2]

In the same vein, Howard Stein, the Chairman of Dreyfus at the time notes,

> "Price-earnings ratios, historic gains in earnings, projections of earnings per share, and many other analytical devices that you and I work with seem to have little relevance of late." [3]

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In the midst of all this, imagine that you're shopping money managers. You're excited about one in particular, because you've heard he's really good, but he's lost 23 percent in 1973 and he's down 50 percent by 1974. Incredibly, as the losses have mounted, he's actually getting more confident!

If we're like most people, we're thinking to ourselves, "If I invested $1 million with this guy at the beginning of 1973, I'd have had $500,000 left by late 1974." We extrapolate the current trajectory. "At this rate, I'll be broke in 2 years! I don't care how brilliant he thinks he is; I'm going pass on this one."

"Oh, that was Warren Buffet? Well, of course I would've stayed with *him*." But, we didn't know today's story at that time. Clearly, those who stayed with him and endured the losses over those two years were handsomely rewarded.

> "By early 1986, Berkshire had broken $3,000 a share. In the twenty one years that Buffet had been turning the veritable dross of a textile mill into gold, the stock had multiplied 167 times; meanwhile, the Dow had merely doubled." [4]

Now, if the only thing we learn from this story is that we need to go invest in Berkshire Hathaway shares, we miss the point. This was yesterday's story and yesterday's returns.

Over the last 32 years, how much of every investor's success has come from inflating the money supply? Clearly to increase the money supply [and debt] in circulation from $474 billion, in 1974, to $10.2 trillion, by March of 2006, has influenced asset prices around the globe. Over the last two decades the Fed Funds rate has been reduced from over 20 down to 1 percent. Clearly, this story is not going to be repeated any time soon. This is the reality that all of us must accept. The circumstances that helped make this possible, do not, and could not, exist in our current economic and market environment. We would do better to ask ourselves, "What things can we learn from this story that could help us become better investors?"

In the late 1990s, the "losers" were those managers who refused to index or to benchmark their portfolios to the overall markets. In seeking to steer clear of risky stocks and sectors that had become historically overvalued, their portfolios "underperformed" the markets. It is not coincidental that, in 2000, as the markets began their steep descent, these same portfolios "outperformed" their benchmarks.

One management company, which made the "mistake" of avoiding high-risk investments, was considered by some of its institutional investors as a "loser" at the time. During the 24 months leading up to 2000, this company's assets under management declined from $30 billion to $20 billion. Still, their unwillingness to compromise and follow the herd, in the late 90s, proved a valuable asset. By the end of 2004, their assets under management had grown to $75 billion. This story, of the cash flows in to and out of GMO, shows us that even large institutional investors tend to chase yesterday's returns. [5]

Michael Covel's book, Trend Following: How Great Traders Make Millions in Up or Down Markets, focuses on trend following hedge fund managers. If the book title sounds a bit out of your league, let me encourage you to read it anyway. The knowledge and insights contained within would be benefit to investors at all levels of the game.

A TRIP DOWN MEMORY LANE

One of the managers discussed in Covel's book is Bill Dunn, of Dunn Capital, who manages over $1 billion for investors. Since first opening in 1974, his long-term track record is enviable by any measure. However, Dunn has had several drawdowns, (temporary losses). One such drawdown lost him his largest client at the time. When asked how he deals with pressure from clients to change how he trades, Dunn responded:

> "A person must be an optimist to be in this business, but I also believe it's a cyclical phenomenon for several other reasons. In our 18 years of experience we've had to endure a number of long and nasty periods during which we've asked ourselves this same question [whether he should change his model]. In late 1981 our accounts had lost about 42% over the previous 12 months, and we and our clients were starting to wonder if we would ever see good markets again. We continued to trade our thoroughly researched system, but our largest client got cold feet and withdrew about 70% of our total equity under management. You guessed it. Our next month was up 18% and in the 36 months following their withdrawal our accounts made 430%!" [6]

When we read about successful investment managers like Buffet, Grantham, and Dunn, we see vast differences in approach and one commonality. They were all willing to accept short-term losses. Investors who looked at these losses, or periods of underperformance (some of which lasted up to a couple of years), and decided to sell, missed out on large gains in the years that followed.

And, it's not just individual and institutional investors who get this wrong. Again and again, even the largest brokerage houses quite often make the same mistakes. Consider the words of Barton Biggs in his new book, Hedgehogging. Biggs, who recently retired from the position of Chief Global Strategist at Morgan Stanley, spoke of the atmosphere at Morgan Stanley in the year 2000.

> "Secular cycles, both in markets and sectors of the market, make a big investment management firm a very conflicting enterprise to manage if you are a businessperson, because *the rational things to do to maximize short-term profitability are exactly the wrong things from both an investment and a long-term profitability point of view*. For example, during 2000, even as the bubble was bursting, Morgan Stanley Investment Management, which has a business-dominated management, acted like businessmen: they heavily promoted the underwriting of technology and aggressive growth stock funds *because those were the funds the salespeople could sell and that the public would buy*. Management was not evil; they were doing what they thought was right. Large amounts of public money were being raised and very quickly lost. Short-term sales profits were collected at the expense of, not only the public, but the firm's long-term credibility and profitability." [7]

As Biggs points out of the short-term focus at the top of a market, he also points out the short-term view at market bottoms.

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> "The firm erred in the other direction in the spring of 2003 when it shut down its Asian Equity Fund, which it had invested exclusively in the Asia ex Japan markets. The fund had shrunk from $350 million 10 years earlier when the Asian Miracle was on everyone's lips, to less than $10 million. At that level of assets, it was a clear money-losing proposition, so it was the right, short-term business decision to close it down. At the time, there didn't seem to be any interest in Asia. I argued vociferously to keep the fund open, and maintained that, as the markets rallied, new assets would come. To no avail. No one agreed with me, and the fact that they didn't was a buy signal." [8]

In April of 2006, the Asian markets of Singapore, India, and Hong Kong, are up 116 percent, 328 percent, and 94 percent (respectively) from where they were in October of 2002.

It should be plain to see that at every level of investing, we are our greatest enemy. And while learning about ourselves as investors is one of the best things we can do to ensure our success, this never has been, and never will be, the primary message of industry marketing and media. As Biggs points out, there are business decisions and investment decisions, and short-term business decisions often seem to take precedence over long-term investment concerns. If we are to become successful investors, we must understand our inherent weaknesses as instinctual beings trying to ensure our (money) survival, and continuously build our resolve to avoid the comfort that can only be found in the herd.

This predicament cannot be overstated. If we invest correctly, we most often take actions opposite of the herd and usually experience temporary losses. We then have to deal with strong instincts and emotions that shout to us, "You're wrong! Go back and do what everybody else is doing. They made money on their last statement. They must be right!" To some extent, we all experience these thoughts, and if we are to succeed, we must learn to overcome them.

So now, we turn our attention to three character traits that we must develop to increase our probability of long-term success in the game of money. I do not expect that these tenets will produce a "Eureka!" moment for us, but we should be warned: These views are easy to academically ascend to, yet nigh unto impossible to sustain when we are experiencing strong emotional or mental stress, such as the kind caused during periods of drawdowns.

WE MUST BE PATIENT

> "But everyone must be quick to hear, slow to speak, and slow to anger"
>
> James 1:19

I am always amazed at the versatility of Biblical wisdom. The author of this book is speaking to how we should respond to trying times. Trials can come from any direction, and we are all well aware that money, or the lack (or loss) thereof, certainly qualifies. When we feel the pain of losing money from different investment ideas, our first impulse is not to listen, but to immediately let our money manager, the party inflicting this pain, know most assuredly that it is our money, that we are in control, and that we will not tolerate such losses.

WE MUST BE PATIENT

In an earlier article, Hard-Wired to Fail: Why we Need Contrarian Managers, I spoke to the fact that, unless we override our own tendencies, the way we are wired as human beings places us at a great disadvantage when it comes to investing. Our tendency to seek the comfort of crowds, multiplies the problem. Think about the stories in this piece. Four different people, with different investors at different times, and yet all of them resulting in the same outcome. Our impatience as investors and the desire to "cut our losses," can cause us to move in the wrong direction at the wrong time.

Earl Hadady, who began his stock and commodity advisory service in 1971 and who developed a way to measure contrary opinion mathematically, comments on our need for patience.

> "Trading opportunities for unusually big profits occur infrequently-maybe only once of twice a year, or not even that often in some futures. Consequently, patience is a required virtue" [9]

In a statement resonant of Barton Biggs' comments about his last years with Morgan Stanley, Robert Prechter alludes to the character flaws in investors and advisors.

> "Might the rare nonherding professional fund manager rise above this dynamic? In most cases, he cannot. His choice is this: He can raise cash in a bull market and buy stocks in a bear market, which would be prudent investing, or he can stay in business. This is his choice. If he acts counter to the market's trend, then his customers leave in droves. Rationality, to most managers, means getting rich giving customers what they want, not losing most of them with prudent investing. Regardless of the market outlook of any specific fund manager, then, the herding majority remains in complete control of the bulk of professionally managed money." [10]

Whether we're professional money managers, traders, or individual investors, we know we need to cultivate patience and self-discipline. But, how do we do this? How can we become more patient with our investment decisions? How can we develop the ability to sit on our emotions and not respond to the sirens of the herd and our own natural tendencies?

WE MUST STUDY

Study…experience…repeat the process. As stated earlier, this is not rocket science, but neither is training to be a top athlete. Though I have since come to my senses, I used to think that I could be a long distance runner. I remember jogging with a friend of mine. Out of shape as I was, he was kind enough to remind me that I was much more likely to pass out (of, say, heat exhaustion or oxygen deprivation) than I was to die, as I was sure I would, of a heart attack. I am glad to report that I never died once. The point is that, like investing, we must learn to ignore our emotions by focusing on other things. Famed Dow Theorist, Robert Rhea knew about the necessity of study. He states,

> "Speculators who 'go broke' are usually those who fail to devote as much time to studying the subject of speculation as they devote to the risking of an equally sum of money in their own business. They fail to realize that no profession requires more hard work, intelligence, patience, and mental discipline than successful speculation." [11]

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It is also worth noting that Rhea was not an adherent of an effortless rise to riches to which so many suggest market indexing will lead us.

Interviewing various managers for our research paper, *Riders on the Storm*, did much to solidify one of my long-held theories. Namely, the tenacity and patience of excellent money managers was built upon, and strengthened by, their ongoing learning and commitment to study. Yet, the unprecedented low volatility of the last few years, has caused many to have a low regard for skill if it is not accompanied by returns equal to, or better than, those of the markets. Thus, we have returned to the point where research and discipline have been replaced by the belief that no one can really out perform the markets. Consider these words from the College for Financial Planning Investments textbook.

> "Perhaps it is conceit that makes some individuals think they can use the dividend-growth model or P/E ratios or price-to-book ratios or any other technique to beat the market." [12]

Compare these words from the leading institution on financial planning with those of Larry Harris, the Chair in Finance at the Marshall School of Business and Chief Economist of the SEC.

> "Trading is a zero-sum game when gains and losses are measured relative to the market average. In a zero-sum game, someone can win only if somebody else loses." [13]

David Druz expounds on this idea.

> "Everyone who enters the market thinks they will win, but obviously there are losers as well. Somebody has to be losing to you if you are winning, so we always like to stress that you should know from whom you're going to take profits, because if you're buying, the guy that's selling thinks he's going to be right, too." [14]

To this, Covel adds,

> "The market is a brutal place. Forget trying to be liked. Need a fried, get a dog. The market doesn't know you and never will. If you are going to win, then someone else has to lose. You don't like these 'survival of the fittest' rules? Stay of the zero-sum game." [15]

Buffet himself states,

> "Berkshire illustrates just how foolish Efficient Market Theory (EMT) is. Naturally the disservice done students and gullible investment professionals who have swallowed EMT has been an extraordinary service to us." [16]

Last but not least, Hadady notes,

> "A futures market is a zero-sum game; that is, the money lost by some speculators and hedgers is exactly equal to the money won by other speculators and hedgers. Note that this statement does not mean there is a trader who wins for every trader who loses. Since some 75 percent or more speculators lose trading futures, the losses of many become the profits of a few. The big money in the market is typically taking positions contrary to what is breaking in the news; that is, they're the idiots who are selling when the news is bullish… who end up winning and heading to the bank." [17]

Okay, I'm pretty sure I've driven that point home enough that we all get the basic idea.

WE MUST STUDY

Many have been lulled into believing that everybody wins in the markets. Reality is much harsher. In a zero-sum game there is a losing trade for every winning trade and there are often many more losing participants than winning ones. With this in mind, since they are a hindrance, we best check our emotions at the door. Rather than relying on the couch potato philosophy of indexing our way to Nirvana, we realize that somebody's going to win and somebody's going to lose, and because we prefer the former to the latter, we recognize the need to study intently. Even knowing this, there is no substitute for experience.

WE MUST RESPECT EXPERIENCE

Continued exposure to stressful experiences improves our odds of overcoming our emotional hard-wiring and instead acting in a more deliberate and logical fashion. This is why law enforcement officers and military personnel drill. Yet, ultimately there is no substitute for real life experience. We would all rather follow a veteran than a rookie. Or, let's look at it another way. If you had to ride in a NASCAR race, where the average speed would be around 188 miles per hour (303 km/h), would you rather ride with a fan that had read quite a bit about NASCAR racing or would you rather ride with someone like Jeff Gordon or Dale Earnhardt Jr?

The point is that we must know when to maintain control and when to defer to those who have gained expertise through experience. All too often bull markets tops produce successes that we attribute to our own skill rather than the more probable reason, which is luck or circumstance. This is not meant to be criticism so much as it is an observation. Fortune smiles upon us and which engenders false confidence. Thus, by and large investors have very little respect for great contrarian investment managers, at or near market tops. This is especially true if the contrarian, in preparation for the next major move in the markets, is losing money or underperforming in the short-term. This has always been the tendency of investors at mania tops.

It is probably worth noting, that my intention is not to complain or defend myself. Rather my hope is that the comments below will encourage those who are contrarian managers and advisors and will enlighten those of us who have hired them, so that we do not make a critical mistake at this juncture in the game.

In the fall of 2000, a writer for a major financial publication made the following remarks about John Henry, a seasoned professional trader who is all to familiar with making tough contrarian calls. The writer states,

> "John W. Henry isn't alone in experiencing hard times. But the firm's losses are among the most staggering. The company's hardest-hit trend-following trading program, called Financial & Metals, was down 18.7% in 1999.... It is unclear whether John W. Henry will make changes to his trading program, one he cooked up decades ago while on a vacation to Norway." [18]

But, like Buffet in 1974, John Henry's time was drawing nigh. The following is a speech he made in November of 2000, one month before he was blasted in the article above.

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> "Unfortunately, markets do not step to a drummer that we control. The period we have just been through has been terrifically painful for investors, brokers, general partners and trading advisors. Drawdowns affect everyone emotionally, psychologically and physically when they persist. It becomes easy to envision a scenario in which things never get better. However, at JWH, experience tells us that things inevitably look bleakest before the tide turns." [19]

Though the investment environment had not been rewarding to Henry during 1999, the fall of 2000 more than made up for it. In October of 2000 Henry's Financial and Metals portfolio was up over 9 percent. In November of that year, it added another 13 percent. Astonishingly, in December the portfolio was up 23 percent, and it tacked on another 3 percent in January of 2001. [20]

And finally, as in all things cyclical, we end where we started. We all salivate at the prospect of making just shy of 50 percent in four months. But, if we were invested in this same program in 2005, we would have experienced a peak to trough drawdown of 21.95 percent and would have experienced a decline of 15.24 percent for the year. [21]

So, if you are losing patience as you wait on the inevitable decline, which will come by the way, and are tempted to let your emotions get the best of you, let me encourage you to do more study. Study what the best minds in the worlds of finance and economics are saying and doing. Study the many manias that our world has seen over the years. Look at the Mississippi Scheme of John Law, the South Sea Bubble to which even the brilliant Sir Isaac Newton succumbed, the Tulip Mania of Holland, the Crash of 29, or the most recent Crash from 2000 to 2002. I trust that you will see quite a few similarities to our own set of circumstances today.

Wall Street is famous for corporate collapses and fund blow-ups. Who could forget Enron? While losses mounted for California, banks, and pension and mutual funds, profits mounted for investors with Jim Chanos and many of the managers mentioned in this article. Commenting on Long Term Capital Management, Covel states,

> "During the exact same period that LTCM lost $1.9 billion in assets, the aggregate profits of five long-term trend followers…exceeded $1 billion in profit." [22]

What will be the next event that drives the markets over a cliff? We don't know. Compressed yields coming unwound with many illiquid players on the wrong side of the trade, bank exposure to derivatives, loan defaults, a collapsing housing bubble, a plummeting dollar, spiking oil, gas and energy prices, war in the Middle East, or something else? The point is that there is a lot risk in our markets right now, and the market looks ripe for a correction. In a zero-sum game fortunes will be made and lost.

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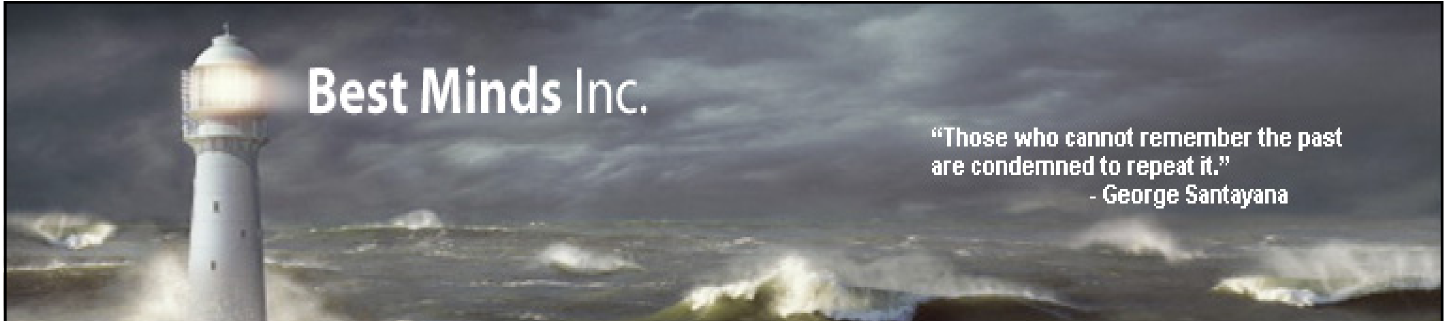

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