

# OUTSIDE THE BELT-STREET

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## WHAT TO DO, WHAT TO DO...

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### SPECIAL POINTS OF INTEREST:

- A Tale of Two Bubbles
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- The Deteriorating Quality of CPI
- When Prices Collapse
- Gold and Cash — Good Enough?
- How to Profit in Down Markets

“But anyone who hears my teaching and ignores it is foolish, like a person who builds a house on sand. When the rains and floods come and the winds beat against that house, it will fall with a mighty crash.”

Matthew 7:26-27

The recent success of having many of my writings picked up has been encouraging. Perhaps the most enjoyable part of this has been the feedback I've received, both positive and negative. Of those who agree with my premise, there seem to be two main camps: The “what should we do?” camp and the “we are in cash and gold and nothing else can be done,” camp.

Don't misunderstand me. I'm not trying to patronize. Inasmuch as we deal in probabilities, the future is always an experiment. As such, we must try to analyze all of our choices before we make a decision. Once a determination is made, we must continue to return to our original, as well as additional, data in order to evaluate our premise.

In this issue, we'll seek to gain a greater understanding of the benefits of non-traditional investment strategies and explore the rewards that come with volatility. Traditional finance assumes that because something is more volatile, it contains more risk. To Benjamin Graham and Warren Buffet, the fact that a stock bounced around did not by itself make it a riskier investment. The Efficient Market Theorist would say that if a stock was cut in half that this would make it riskier. Yet Buffett says, “I have never been able to figure out why it's riskier to buy something at \$40 million than at \$80 million.” In describing the major bottom of 1974, when investors and advisors were showing a great deal of fear, the antithesis of today's all time highs in bullish sentiment, Buffet recalls, “Fund managers who had been eager to buy the nifty fifty at *eighty* time earnings were unwilling to buy Affiliated at five times. What these managers feared was the possibility not of being wrong, but of being out of step. They were worried about being second-guessed—not over the long term, but quarter by quarter.” Buffet: the Making of an American Capitalist Pgs. 157, 316

At this juncture in the markets and financial history, a clear understanding of the next major trend for the stock indices and how fast prices could change is of critical importance. If you understand this and the tools available to the investor, you stand the highest probability of capitalizing from this move when it comes. The more I learn, the clearer my decisions become.

**A CURRENT VIEW — A TALE OF TWO BUBBLES**

Who could forget the late 90's. Remember all the ridiculous book titles for how to become millionaires, or at least rich, through investing in the NASDAQ. If you didn't know what you were doing, that was okay—all you needed to do is go down to the local book store. Who could forget books with titles like Fast Stocks/Fast Money, and How to Buy Technology Stocks: A Guide to Low-Risk, High-Profit Investing. I had to smile as I browsed the titles in the Business section of the local Barnes & Noble. Titles like, The Millionaire Real Estate Investor: a Handbook for Identifying and Developing Investment Properties, Real Estate Millions in Any Market, and Making Big Money Investing in Real Estate. How painfully these titles must compare for real estate investors. On second thought, I doubt most of them, out buying pieces of dirt to sell to the next greater fool, even make the connection.

Or consider Greenspan's concern that, "America's economic imbalances, most notably the large current account deficit and the housing boom," could end in "more-wrenching changes in output, incomes, and employment."<sup>1</sup> Greenspan's culpability aside, this warning resonates with the tones of his words on "Irrational Exuberance".

Do we remember that CMGI closed at \$326.43 on 1/3/2000, that AOL closed at \$93.81 on 12/13/1999, that WorldCom closed at \$63.50 on 6/18/1999, and that Global Crossing closed at \$98.25 on 9/5/2000. Some of those prices are hard to fathom, but these were the internet darlings back then.

Now, we see a mobile home, albeit Malibu, California provides a great view, sell for \$1.4 million dollars, and that doesn't even include the property that it sits on.<sup>2</sup> No wonder only 27 percent of Californians can afford to buy a median-priced home.<sup>3</sup> Or consider [www.condoflip.com](http://www.condoflip.com), debuting from Miami, where you can flip condos or buy and sell lots where a condo will soon be built.

We agree that the NASDAQ was a bubble. It "only" went up 564%. Over the same timeframe, the S&P 500 Homebuilder, a proxy real estate activity, is up 925%. Now that's a mania.

If you want to know how property bubbles have historically ended, look for the piece I'm calling, "Credit in the Wild, Wild West." It should be out soon.



Sources:

1. <http://www.federalreserve.gov/boarddocs/speeches/2005/20050826/default.htm>
2. [http://www.usatoday.com/money/perfi/housing/2005-07-05-million-dollar-trailers\\_x.htm](http://www.usatoday.com/money/perfi/housing/2005-07-05-million-dollar-trailers_x.htm)
3. <http://www.bizjournals.com/sanjose/stories/2003/07/07/daily48.html>

## THE EMOTIONAL FACTOR — DEATH TO SANTA?

Gillespie: “Doug, do you want to kill Santa Claus?”

Wakefield: (laughs) “What? Of course not.”

Gillespie: “You do know, don’t you, that’s the way most investors view negative news about the markets. Like you’re killing Santa.”

Since he began his career as an economist in 1968, Doug Gillespie, of Gillespie Research, has seen many changes in the investment world. He is one of the few who has actually experienced the long bear market of the 70’s. He saw the human, emotional responses of investors over that time.

Conversely, most of us have never experienced a long bear market. (Perhaps that’s why Gillespie’s words stuck with me.) Sure, some are old enough to remember the markets of the 1970’s, but since most Americans have accumulated their wealth over the last 25 years, they don’t have strong feelings regarding that market. Most of us think something along the lines of, “we had a rough time in 2000 to 2002, but Greenspan fixed things, and we started making money again.”

These thoughts are reinforced by Wall Street and the investment advisory community. And why shouldn’t they reinforce this notion? After all, down markets are not good for investment product sales. In fact, history has shown them to be very hard times for investment firms. Even those who are set up in fee-based arrangements, find their own livelihoods depend on the assumption that bear markets are short affairs. If another 2000 to 2002 scenario unfolds in front of us, many of them will go out of business. The bear is just too painful to consider.

Or, consider the investor who has built all of these beautiful plans that he wants his advisor to help them achieve. Another bear market, and these dreams are lost. As the investment community continues to be confronted with these harsh realities, it is easier to deny reality of another bear. So, locking arms, investor and advisor alike, continue to march to the tune of the rising market. Anyone who opposes is seen as unpatriotic and almost anti-American.

In a recent interview in Pensions & Investments, the head of an investment firm, managing \$13.7 billion, is asked what her future return expectations are. She states, “**8.5%**; no surprise here,” and then goes on to use impressive sounding, technical jargon, but never mentions that her assumptions have no historical basis. Just look at Ed Easterling’s [20 Year Stock Cycles](#). Since today, we are at a higher price-to-earnings (P/E) ratio than 1929 and the 20-year average return in the top decile is **3.2%**, history tells us that 8.5% is highly unlikely.

I hate to be the one to tell you this, but Santa isn’t real and the years of 8% and better returns from being in a long only, buy and hold strategy are over. The times are changing, and we’ll be better off when we come to grips with this fact.



## DISTORTIONS: THE INFLATION MEASURE PROBLEM

The deterioration in the quality of government reported inflation measures, namely the Consumer Price Index (CPI), has serious and far reaching implications. The complete disconnect between the reality of our everyday lives and the government reported numbers is most plainly obvious in the price of gasoline. Thank God, its not a part of “core” inflation measures, otherwise we’d really be feeling it.

For example, consider that the seasonally adjusted gasoline portion of the CPI shows that gasoline prices declined 4.4% in May and 1.2% in June, and that gas prices have only increased 6.9% since June 2004. <sup>1</sup>

Never mind the fact that every time I’ve gone to the gas station over the last few months, its cost me more and more to fill up my tank. The government shows the price has gone down, so that must be correct. Or is it?

Retails gasoline sales tell a different story. Retails gas sales show a decline of 0.5% in May and an increase of 1.9% in June. Additionally, retail gas sales show an increase of 16.2% since June of ‘04. The government’s own Energy Information Agency (EIA) supports this data as it shows prices have increased 14.9% from June 2004. As volume changes tend to be small, retails gasoline sales are mainly affected by changes in the price of gasoline. If anything, increasing gasoline prices should tend to reduce the amount of gas we purchase. <sup>2</sup> So, how did we get here?

Originally CPI was calculated as follows: a fixed basket of goods was purchased on a periodic basis, and the change in the price of that basket represented inflation. In an effort to calm down the rapidly rising CPI numbers of the early 90’s, the substitution effect was introduced. The argument was that if steak got too expensive, we’d buy hamburger instead. Thus, the CPI began to measure changes in the cost of survival rather than changes in the cost of living. Then, geometric weighting was brought in, giving a lower weighting to components with rising prices and a higher weighting to those with dropping prices. Next, hedonic price measures were initiated. Here, prices of goods are reduced for the increased pleasure the consumer derives from their use. In other words, that computer didn’t cost you 20% more this year because you got an offsetting 20% increase in the pleasure you get from using it. Never mind that rents are substituted for home prices, that “core” inflation has strayed far from its original intent, and that we are now using “intervention analysis” to smooth out violent price swings in gas prices. CPI is low, and that means inflations is contained. <sup>3</sup>

If the government is willing to engineer the numbers this much to affect our perceived standard of living, what else would they be willing to do? As you ponder this, consider Keynes’ and recent Fed Governor Bernanke’s remarks to the right.

Sources:

1. <http://www.bls.gov/news.release/cpi.t02.htm>
2. John Williams’ “Shadow Government Statistics” June CPI Hanky-Panky (July 15th, 2005 Alert)
3. John Williams’ “Shadow Government Statistics” Series—Government Economic Reports: ‘The Consumer Price Index’ (September 22, 2004)

“These people are, perhaps, even more influenced in their readiness to spend by rises and falls in the value of their investments than by the state of their income...a rising stock-market may be an almost essential condition of a satisfactory propensity to consume.”

-John Maynard Keynes The General Theory... Pg. 319

To stimulate aggregate spending when short-term interest rates have reached zero, the Fed must expand the scale of its asset purchases or, possibly, expand the menu of assets that it buys.

- <http://www.federalreserve.gov/boarddocs/speeches/2002/20021121/default.htm>

**TECHNICAL PICTURES – WHEN PRICES COLLAPSE**

Today, we’re going to look at two big blue chip companies that have been in business over 125 years. One of these companies has seen its stock climb from \$5.27 in January 1992 to \$45.93 as of August 23, 2005. For this timeframe, the stock has a 17.14% compounded return or a 772% overall increase. The other blue chip company has seen its price climb from \$12.74 to \$27.51 in the ten years ending August 23, 2005, managing a 116% return for this period, or a compounded return of 8%. Remember, these are world leading companies. The first company is “the world’s leading supply management and healthcare information technology company.” The second company is “a global professional services firm with revenues exceeding \$12 billion. Today its approximately 60,000 employees provide analysis, advice, and transactional capabilities to clients in more than 100 countries.”

If this were as far as we looked, we’d likely be ready to invest. Indeed, either through their own individual investments or through pensions and endowments, millions of investors have done this very thing.

However, since these are such large companies that affect the lives of investors, employees and the communities that they are located in, the large price drops in one to four day periods must be addressed.

On April 28, 1999 shareholders of McKesson stock woke up to see their stock 48% lower than when the stock market closed the day before. Was this just random chance? Sadly, no. McKesson had just purchased fast growing HBOC. The problem was that HBOC entered into “side letter” agreements between hospital customers and its own sales representatives. Since GAAP rules state that sales cannot be recognized until all (Continued →)



**HISTORY: WHEN PRICES COLLAPSE**

contingencies are satisfied, no revenue from these contracts should have been booked. But, of course, it was. HBOC also backed-dated contracts to boost their first quarter earnings.<sup>1</sup> When the year end audit revealed these accounting tricks, the reality of accounting manipulation trumped the stellar earnings, and McKesson took the fall.

Marsh & McLennan's trouble occurred in 2004. Investors went home on October 13, 2004 with the stock at \$45.33. Four days later its stock price had dropped to \$23.68, a 48% loss.

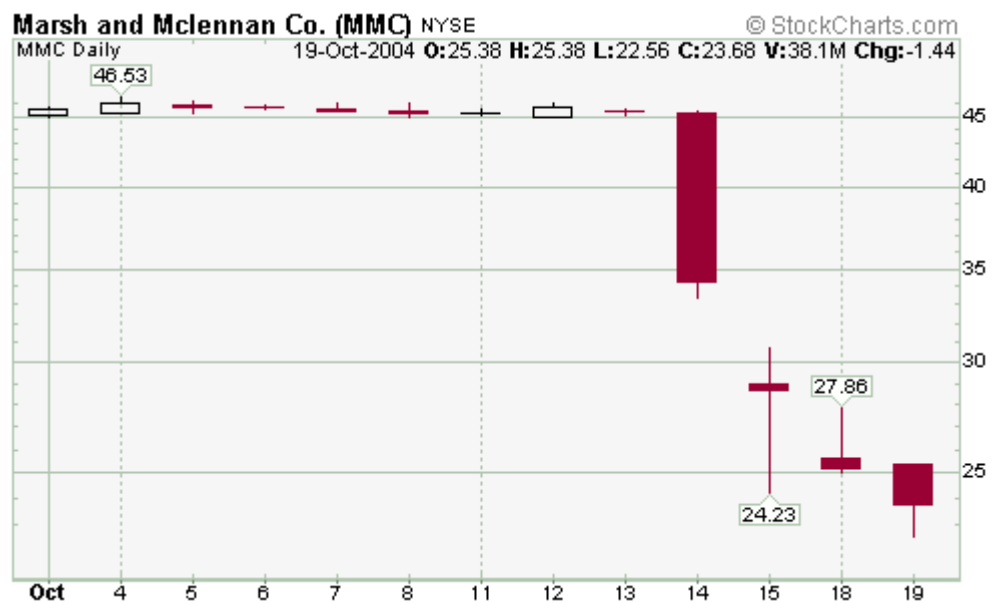
The cause? Eliot Spitzer had filed a class action suit against Marsh & McLennan, as the SEC claimed that the statements of Marsh & McLennan were false and misleading. They had failed to tell investors that Putnam was engaging in late day trading (the illegal buying and selling of mutual funds after regular market hours) for

the benefit of specific investors and fund managers, and that in exchange, Marsh & McLennan would deposit assets. These "sticky assets" had allowed Putnam to overstate their assets under management and Marsh & McLennan to receive a steady flow of fees from these "sticky assets".<sup>2</sup>

Sadly, as rampant as accounting fraud has become today, these are not isolated incidences. Investment advisors can either spend their time trying to conform to the crowd, buying large blocks of ETFs, or looking for what stocks to avoid or sell short in order to profit when the fraud is revealed.

Sources:

1. [Financial Shenanigans](#) (2002) Howard Schilit. Pgs. 86, 87
2. <http://securities.stanford.edu/1029/MMC03-01/>



**EDITORIALS: GOLD & CASH— GOOD ENOUGH?**

As the previous piece on McKesson and Marsh & McLennan points out, things can change quickly. In fact, they can change so quickly that those who wait until the last moment will not be prepared. True, one can reduce the risk of individual stock volatility by buying an index, but if the masses start selling, one can still get hammered. See also 1987 or 2002. Many investors and advisors assume, a priori, that cash and gold are the most appropriate investments for bear markets.

Instead, let us examine more closely what we can learn from probability, volatility, and history regarding using cash instruments, buying gold, and selling short. Though far from comprehensive, this brief overview should stimulate each investor to further study of additional investment possibilities.

1. Cash — Because of its familiarity and lack of volatility, as well as legal constraints placed on institutions, pensions, endowments, and trusts, in down markets, cash is the investment of choice for most investors. However, we realize that these investors have a high probability of underperforming tools that can directly short the major indices. If an index falls 20% in 6 months, it is impossible for cash to outperform a strategy that is heavily shorting the broad markets. So, as shorting strategies hold high probabilities for losses in up markets, they also stand high probabilities for gains in down markets.
2. Gold — With the world awash as never before with fiat currency, and with the ability to create tons of paper money with a printing press, bullion maintains its role as a true store of wealth. While no historian can disagree with the place that gold has held in monetary history, it is still appropriate to explore why history has shown that gold does not always have an inverse correlation to the broader stock indices. Since the bottom of 2002, we have seen gold and gold stock move up sharply with the broader markets. We have seen the Dow and the HUI, the gold bug index, move sideways since the beginning of 2004. The record also shows that gold *stocks* trended downward with equities in 1987. With the changes our world is facing, this is certainly not a criticism of gold and its place. I am simply stating that a study of history reveals that it does not always have a direct inverse correlation to the markets.
3. Shorting — The reason that this tool will always carry fewer investment dollars, is that it is not easily understood. However, today there is a very large short exposure in the ETF markets. As well, the Chicago markets offer the use of put options and futures contracts which can move directly opposite of the market. If the markets fall, your probability of gain is very high. If the market moves up, your probability of loss is very high. So the most essential question is, “Where is the market headed in the next few years, and how does its current value compare to past historical cycles?”

Remember, history and nature reveal that the longer prices stay constant, while other variables (i.e., gas prices, credit levels, housing prices...) continue to change radically to the upside, the higher the probability of a sharp and sudden spike in volatility. The highest probable way for an investor to capitalize on the change, when it occurs, is to prepare to take advantage of it before it happens. As evidenced by Buffet's experiences, it seems better to position oneself early rather than trying to beat large program trading platforms, when the “switch is flipped” to sell. Caution: I have come to respect the fact that traders and managers that use shorting tools are not only highly skilled at their trade, but have incredibly strong resolve.

*Disclaimer: This should not be construed as advice to buy, sell, hold, or sell short.*

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**With the “Perfect Financial Storm” brewing in front of us, our actions are more crucial now than ever.**

**“ THOSE WHO CANNOT REMEMBER THE PAST ARE CONDEMNED TO REPEAT IT.” GEORGE SANTAYANA , 1905**

## OTHER OPTIONS

Below I have listed three options which are discussed in more detail in our June newsletter. In addition to these, let me also address my thoughts on gold *today*. People feel strongly about money. And, as some say gold is “the only true money”, people feel even more strongly about it. I do not wish to invite the ire of my gold bug friends and investors. Gold is constantly in my thoughts and there is a great deal of excellent current and historical work supporting the purchase of gold.

However, from my sources on Elliot Wave, historic examples of gold price movement, and the inflation/deflation debate, in considering gold as an investment (not money) at this current juncture there are other tools with a higher probability of profiting in a declining stock market. That said, I continue to monitor *metals* and gold for an entry point, and I never forget that gold is the oldest tool in the financial markets today. To ignore its impact, would be the equivalent of calling Buffet a has-been in 1999 at the dotcom top.

1. Short Only Managers — These managers who specialize in shorting stocks and markets.
2. Inverse and Bear Market Funds — There are three mutual fund companies that offer inverse index funds, giving the investor the possibility of profiting in a declining market.
3. Long/Short Trading Managers — Not necessarily hedge funds. We have screened down to a very small group of managers who can trade in and out of index and inverse index funds or buy or short sell ETFs.

Disclaimer: Nothing in this newsletter should be construed as advice to buy, sell, hold, or sell short. The safest action is to constantly increase one's knowledge of the money game. To accept the conventional wisdom about the world of money, without a thorough examination of how that "wisdom" has stood over time, is to take unnecessary risk. Best Minds, Inc. seeks advice from a wide variety of individuals, and at any time may or may not agree with those individual's advice. Challenging one's thinking is the only way to come to firm conclusions.