

## Four Critical Questions

Doug Wakefield with Ben Hill

- Does tracking the major US equity markets give us a full grasp of the amount of risks in our capital markets?
- Absolutely not. Consider this: Over the last 14 months, from the end of 2006 to the last day of February of 2008, the Dow Jones Industrial Average and the NASDAQ 100 are only down 1.58% and .63%, respectively. But, if we look at some of the major SECTORS of our economy, we get a different picture. For example, over the same timeframe, the retail index (SRLX) is down 22.85%, the housing index (SHGX) is down 42.55%, the brokerage index (SXBD) is down 24.90%, and the banking index (SBKX) is down 29.91%, while the healthcare index (SHCX) is only down 2.32%. So, four major areas of our economy are down substantially, and neither the Dow nor the NASDAQ 100 has reflected this reality. This could be one of the reasons why many trading strategies will fail; they don't recognize how misaligned the major equity markets are with the *real* economy, so they may not be prepared. Also, if the economic sectors that have not come down hard are fundamentally driven by business and personal spending, and *that spending* is driven by the amount of *credit* people are willing to take, then the areas of our economy and markets that have yet to be affected, will soon join the rest of the economy in a general decline.
- What do you think is one of the biggest risks to traders and investors right now?
- Their own biases as formed by their experiences. I remember going to New Orleans a couple of times over the last 20 years – before Katrina. When I left the downtown area and headed back to the airport, it amazed me to see the number of houses that were lower than the level of the highway. The only thing keeping them from flooding, were the levees. In hindsight we can see that if they had a major storm, with an enormous amount of rain, this could be a huge problem. When interviewers asked those who stayed why they did so, I was amazed by their responses. In so many words they stated, “We had been through a lot of storms, and nothing that bad had ever happened, so we decided to stay put.” We are wired in such a way that the only warnings we are inclined to act upon, are those that will help us avoid things we have personally experienced. One could even say, “The only things that are *real* to us are those that we have experienced.” And that's the point: the only thing most New Orleans' residents had *experienced* were dire warnings and minimal consequences. All because it had never happened to *them* before.

In science, we call these rare events fat tails. We know they're out there, but because they happen so infrequently, most people don't spend time studying fat tail events or their similarities. Those that do could be labeled as "gloom or doomers" by their colleagues. But, when we study nature, fat tails are almost always occurring somewhere on some level. As long as we live in Idaho, Katrina is just a news story. But if we run a business in New Orleans, it's our life.

- What do you think is the root problem of all of this?
- In a word – *debt*. In the early 1970s, after the US dollar was removed from the gold exchange standard – a standard that was supposed to limit the amount of debt the system could create – the dollar drew its "stability" by being tied to oil. Since then our system has become progressively less stable and the global markets have seen more fat tail events occur. This is partly due to the fact that the system has never been allowed to return to equilibrium, which all systems seek. The solution was always the same. We solve today's debt crisis by creating more debt – more government bailouts. Consequently, the next future financial structure becomes even less stable. As fear sets in, borrowers and lenders become less inclined to play their respective roles, and the inflationary policies and schemes that attempt to thwart the natural forces of unwinding are eventually overridden.

Without realizing that the foundation upon which our money is built has changed every few decades, since the creation of the Federal Reserve in 1913, many bulls and bears mistakenly believe that the Fed is all-powerful. Specifically, it appears that most people have come to believe that the Fed will always be able to "print" more money to get us out of our current crisis. To them, every rate cut or short-term loan is a sign that inflation will continue unabated into the foreseeable future. Thinking that the Fed will always take care of any problems we encounter, millions of bulls have been lulled into thinking that studying monetary and banking history is useless. And though the bears are typically more aware of monetary history, they have come to believe that central bankers' expansionary policies will continue with no end in sight. We fail to recognize the markets' signals since July of 2007, suggesting that the rate cuts and government bailouts are not working. As we look at various capital and debt markets over the last eight months, do we see signs of more or less confidence? Are we seeing smoother monetary flows between buyers and sellers in our debt markets, or a breakdown – literally at the operational level – in some of our debt markets? Is this normal? If we study market history, how often does this type of action precede major downward moves in equity prices? If consumers and businesses continue to

reduce spending and cut debt, what effect will cutting rates and offering short term loans have on the markets? What will happen when the current petrodollar, just like the gold exchange dollar prior to August 1971, no longer exists?

While some might look at all this with more than a bit of skepticism, I draw my conclusions from vast amounts of reading. And from what I've read, it is obvious that those at the highest levels of finance, central banking and politics have given this a great deal of thought. This is not to suggest that we should all go back to sleep and leave the "driving to...*them*." Rather, as quickly as possible, we should start learning about how to place the odds in this financial game more in our favor. After spending more than 8000 hours researching, reading, and writing, since 2003, I am convinced that the structural problems we have noticed in our markets and economies in the last few months are endemic. I would say that the odds of a significant downward adjustment in global equity prices during the next 90 to 180 days are extremely high. Science, history, and crowd psychology show hundreds of parallels to previous moments in history.

- What would you encourage every investor to do right now?
- Understand that science and crowd behavior are ten times stronger than any academic or fundamental argument. When panic and fear set in, the psychology of the crowd will crush those in its path without regard for past performance, prestige or degrees. If you do not respect these powers, your very career and portfolio will bear the brunt of the damage. This is the stuff of fat tail events.

Clinging to false ideas of investing and history proved detrimental during the 2000 to 2002 decline, not only crushing my clients and my portfolios, and my income, but my image of myself. From studying historic declines what grieves me the most, is knowing that as equity markets re-price themselves to correspond with the real world of banking, real estate, and retail spending, thousands of professionals are going to suffer a similar fate. So, until they understand where we are in history, I encourage advisors and investors to find the safest havens of cash to hold their funds.

Traders must remember that all the major equity markets around the world are below their 2007 highs. All good traders know that trends come to an end. So if you have recently been making money rapidly from areas of the markets that have been moving almost straight up, would it not make sense to develop an exit strategy to lock in gains at some point? Shouldn't we be watching for the *end* of the trend and developing our strategies accordingly?

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