

If It Works, Is It True?

by Doug Wakefield with Ben Hill

About two weeks ago, I attended a function at my sons' school, where a gentleman named Josh McDowell spoke. Mr. McDowell has been working with youth over the last 45 years and has spoken to more than ten million young men and women during this time. After he spoke to the junior high and senior high classes in the morning, McDowell returned for an evening session to speak with the parents. While the entire session was excellent, allow me to share one of his rather profound insights with you.

- In the 1960s, a young person would say, "If it is true, it will work."
- In the 2000s, a young person would say, "If it works, it is true."

It is not my intention to delve into the far-reaching ramifications of this change, but rather, to point out one example of how pervasive this line of thinking has become. As I've been in a defensive posture for the last three years, I've detected a derivation of this thought process in many a market participant. To wit, in January of 2007, many investors would say, "If it hasn't worked, it must not be true." Actually, most arguments go more like this, "Did you make as much money as the Dow or S&P 500 last year? If not, enough said. The bottom line is all we need to know." As the markets have continued their gentle float to the heavens on the sea of tranquil liquidity over the last few years, investors are once again content to index their way to prosperity (and happiness).



And, as this chart of the VIX (above) reveals, on January 24th of 2007, the VIX recorded its lowest reading in 17 years. Understanding this index is quite simple: the higher the reading, the greater the belief that the Dow Jones Industrial Average (DJIA) will experience an increase in volatility in the near future – or the greater the perception of risk. Likewise, the lower the reading, the greater the belief that the DJIA will experience

a decrease in volatility in the near future – or the lower the perception of risk. Clearly, many investors believe that it doesn't matter what happens in the real world. They believe that the great social engineers of our day have created an eternal state of bliss, where all risks can be hedged away.

A quote from our December newsletter, MindGames, in which we interviewed Dr. Janice Dorn, explains why this is problematic.

“When an individual has been in the amniotic sac – when we have been ‘cocooned’ – and then the cocoon is gone and we are presented with making choices that we were not used to making before, the neo-cortex [the thought center of the brain] becomes overwhelmed. Since, when placed under a great deal of stress, the brain cannot process this much conflicting information (upon which decisions much often be made) it defaults to the limbic system [the emotional center of the brain]. And by reverting to the limbic system, we make decisions purely on an emotional basis.”

The most glaringly obvious defect of the buy-n-hold, indexing method of investing is that it doesn't take real-world, economic issues into consideration. The unspoken and often unnoticed assumption is that history is totally worthless in its predictive value.

Currently, we could choose from a grocery list of issues that could give the VIX cause for concern. For example, consider the following news headlines from the last few weeks.

- “US Warns Iran to Back Off Attempts to Dominate Region,” [Wall Street Journal](#), January 23, 2007
- “U.N. Atomic Chief Cites Iran Enrichment Plan,” [New York Times](#), January 26, 2007
- “Chavez and Iran to Unveil Anti-US Fund,” [Al-Jazeera](#), January 15, 2007

In the January 2007 issue of The Investor's Mind: [Persia- Fuel on the Fire](#), we explore the history of Iran. The geopolitical events that are centering on the UN Security Council, the US, and Iran prove once again that an understanding of history is critical to investors at any and all levels of the game. In that issue, we answer the following questions:

- How does German, Russian, British, and American history come together in Iran during the first half of the 20th century?
- What does the Treaty of Versailles have to do with Iran in January of 2007?
- What does the Tehran Conference, held in 1943, have to do with the UN Security Council today?
- What was one of the first court cases brought before the newly formed United Nations?
- What effect has Dr. Mohammed Mossadegh had on Iran and how do Iranians view him today?

Or, better yet, consider the risks that two high level international banks bring to the fore. The [Bank of International Settlement's Quarterly Review](#) states that investors are not

being appropriately compensated for the risk they are taking in this considerably uncertain economic environment:

“In an environment where *considerable uncertainty* seemed to remain about the direction of economic growth, inflation and monetary policy - in particular in the United States - prices of options on government bond and stock index futures implied *very low levels of near-term volatility*. At the same time, estimated US term premia indicated that *investors required almost no compensation at all for bearing risk* associated with uncertainty in future inflation and real interest rates.” [Italics mine] [Page 11]

The December 2006 issue of the [International Monetary Fund's Global Financial Stability Report](#) points to distressed sub-prime lenders and increased borrowing as investors continue to try to hold onto their positions that are declining in value.

“The U.S. Housing market *slowdown has been more severe* than some market participants had expected. However, markets still expect this not to trigger broader economic weakness in the U.S. economy, and *they view global growth prospects as remaining positive*. Nevertheless, the housing slowdown has increased concern about the sub-prime segments of the U.S. mortgage markets, and some early signs of distress in that sector are emerging.

Leverage is increasing rapidly in private equity markets and *valuations appear increasingly stretched*. Rating agencies warn that private equity-sponsored companies may come under stress should global economic conditions weaken significantly.” [Pg1]

When we combine the lowest levels of fear in 17 years with the conflicting interests of the UN Security Council, Iran, and the US and the financial concerns expressed by the BIS and IMF, this does not bode well for market bulls.

With a historically long period of minimal downside market movement is it any wonder that investors, and advisors alike, are asleep? Five short years ago the markets declined 30 percent in just 4 months. Yet, the reality of the market's ability to lose so much so fast has been explained away or forgotten.



If you've come to the point where you realize that nothing in the investment world should be taken for granted, I invite you to join those from 41 countries, who have [signed up](#) for our [educational services](#). Those who sign up for our monthly research newsletter, The Investor's Mind, will also get access to our 154-page industry research paper on short selling, [Riders on the Storm](#).

For those of you who have taken a defensive posture over the last few years and have suffered criticism or financial loss, let me encourage you to reread the words of McDowell at the opening of this article. If it's true, it will (eventually) work. For those of you who are debating whether or not the markets will turn down and whether or not the possibility of a market downturn should motivate you to read, I leave you with the words of Henry Blodget, lead Internet analyst at Merrill Lynch from 1999 to late 2001. In an interview with author Maggie Maher, Blodget said:

“If I had only read that book [John Kenneth Galbraith's book, **A Short History of Financial Euphoria**] at the beginning of 2000. It would have been worth a million dollars to me then.”

Doug Wakefield,
 President
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