

# OUTSIDE THE BELT-STREET

JUNE 2005

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## SPECIAL POINTS OF INTEREST:

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## BALANCED THINKING IN AN IMBALANCED WORLD

How quickly we forget. Yet, it was only a little more than five years ago that the U.S. experienced a stock market crash, correcting, to some extent, the previous mania.

How can we possibly be playing the exact same game, again?

We aren't. Today, it is worse. In 2000, national savings was \$817 billion (8.3% of GDP). In 2004, it shrunk to \$212 billion (1.8% of GDP). In 2000, private household debt was \$558 billion (97% of private household income). In 2004, it was \$1,018 billion (120% of private household income). Then, the US current account deficit was \$413 billion, and the federal government ran a surplus of \$259 billion. In 2004, the deficit was \$666 billion, while the government ran a deficit of \$362 billion. And the list could go on, ad infinitum, ad nauseam. Needless to say, these historical imbalances are creating extreme pressure points on the markets.

The old Wall Street bromide goes: "What's the difference between being early and being wrong?" Answer: "Nothing."

Surely, there is some truth to this, yet, on an absolute basis, we beg to differ. If one is simply wrong, no amount of time will make him right. However, if one is right, eventually, his discernment of macroeconomic and market trends will profit.

Let me be more specific. We first told our clients that the bear market rally from October 2002 had ended around late January and early February of 2004 with the NASDAQ at 2,163 and the DJIA at 10,753. While these numbers held throughout the year, they were challenged by a higher top of 2191 on the NASDAQ and 10,984 on the Dow in the first quarter of '05. Do we throw out our understanding of the market because of one call? No. We go back to the lab and continue watching numbers and patterns. We added more research and reassessed and reinterpreted the patterns that had unfolded in the markets. With the Dow closing at 10,274 and the NASDAQ at 2,056 at the end of June 2005, was the call for a top in 2004 harmful to investors who followed those timing signals and left the markets? The answer looks to be no, yet only time will tell.

As the pressure on the markets has increased greatly over the last two years (i.e. rapid increases in credit/debt, trade deficits, real estate prices, oil prices...et al), while market prices have stayed in a rather small trading range, our study of history and science shows this will not end well. The time to act is now.

## A CURRENT VIEW OF THE STORM — ETF GROWTH

Investors fallaciously overemphasize past averages as they make assumptions about the market's future. Though the past can certainly help us assess the future, if we ignore how new investment vehicles have change the market's landscape, our plans are less likely to succeed.

Exchange Traded Funds (ETFs), collective investment vehicles which track indices, are a relatively new tool in the financial markets. They allow low cost exposure to the performance of an index as quickly and as efficiently as the most liquid stocks. As we consider the ramifications of masses of investors clamoring to the "safety" of low cost indexing, our problems begin.

First, like index funds, ETFs create distortions and inefficiencies in the markets. For example, if we purchase an ETF that tracks the S&P500, we make no judgments to the soundness of each company other than each is large enough to be listed on the said exchange. We are not deciding if company A is a good company or undervalued or if company B is a poor company or is overvalued. We are simply buying it because it is on the index. The effect is that overvalued companies become more overvalued and undervalued companies become fully (or over) valued. As masses of investors focus on cutting cost and not underperforming the market, the whole market can become overvalued. In fact, according to Thompson Financial, there were over 1400 institutional investors holding ETFs as of December 2004. This represents billions of dollars influencing the markets based on a basket of stocks rather than a thorough look at individual companies. Does this sound like movement toward a more stable market?

Second, unlike index funds, ETFs can be bought and sold throughout the day and can be used to allow the investor to short the entire market. And, unlike individual stocks which are required to short on an up-tick, ETFs allow the investor to short on a down tick. In other words, in a declining market, short sellers of individual securities have to wait for an up movement in the stock in order to short that stock, whereas the short sellers of ETFs can continue to short into a decline, thus accelerating the sell off.

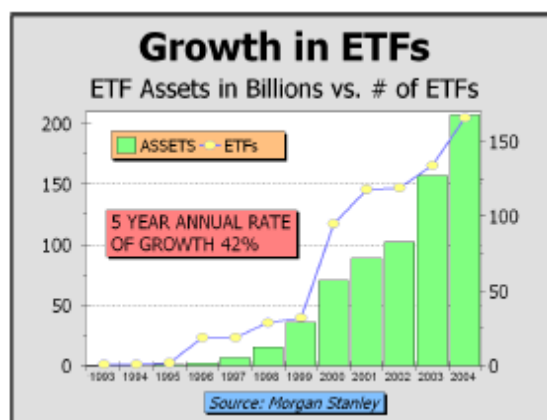
To further illustrate the magnitude of the possible effect on our markets, consider a recent research report on ETF short interest. In October 2002, the short interest percentage stood at 24% on the NASDAQ 100 Index and 19.3% on the S&P 500 Index. By January 2004 this variable had grown to 52.8% on the NASDAQ 100 and 29.9% on the S&P 500. And this was during an up market.

With the vast number of investors piling into ETFs, one can only wonder what effect this could have had if ETFs existed in 1987.

Sources:

1. "Everybody's Favorite Trade" — December 16, 2004 issue, Alan Newman. (chart to right included) To learn more about his writings visit [www.cross-currents.net](http://www.cross-currents.net)
2. **Short Selling, Strategies, Risks, and Rewards** — 2004, Edited by Dr. Frank Fabozzi at the School of Management, Yale University. Data collected by Gary Gastineau, Managing Director of ETF Consultants, LLC. (pg 45)

"ETFs have grown at a 42% rate over the last 5 years. If the Dow had grown at this rate over the last 5 years it would be over 66,000 today."  
Alan Newman,  
Cross-Currents,  
December 16, 2004



## THE EMOTIONAL FACTOR — SKILL OR LUCK?

In last month's editorial, I wrote about how investors have a bias towards recent past performance. When we evaluate the managers we are using, we have a strong propensity to overweight the latest performance. If we have had losses while others have had losses, we may decide to stay the course. If we have had losses while others have had gains, our emotions start screaming, "this must be wrong!" In order to overcome problem, our logic must take over. But does it work the other way? Can this focus on recent performance be so strong that we become convinced, that because the numbers have been "good", that we must be doing the right thing?

In the Book Review section of our website, you will find a sound file called, "Fooled By Randomness" by Nassim Taleb. Taleb, a professional options trader and passionate mathematician, unearths some very interesting insights on how our natural human behaviors can lead us to totally erroneous conclusions about our "success" in the markets.

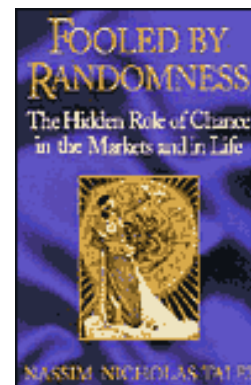
In the next few weeks investors will perform the sacred ritual of reviewing their quarterly numbers. For many retail investors, they will focus on one thing. Did I make or lose money? For institutional investors, the question will be a little more sophisticated. Did the manager perform well against their respective index?

And yet as we review these numbers on a page, we can miss something that would give us much greater insight into our future potential for success. Was the success of the manager based on random luck or skill?

Taleb, gives us insight into this question based on his reading of a Greek philosopher, Solon. "That which came by luck could be taken away by luck (and often rapidly and unexpectedly at that.) The flipside, which deserves to be considered as well, (in fact it is even more of our concern), is that things that come with little help from luck are more resistant to randomness." Skill becomes crucial during bear market declines. "It does not matter how frequently something succeeds if failure is too costly to bear."

Taleb illustrates this problem of depending on luck very poignantly with a story of a professional bond trader during the emerging markets boom prior to late 1997. Coming from Latin-America, Carlos had firsthand experience with emerging markets. He studied for his PhD at Harvard and began his career in 1992 for a New York investment bank. He developed and stuck to his principle of "buying on the dips." By early 1998, the upward climb of the market had convinced him, and many others, that this technique was contributing to his success. In 1998, things broke down. The Russian bonds, averaging \$52, started falling. Buying on the dips was put into action, but by August bond prices fell through the \$30's, then the \$20s. When the bonds traded below \$10, Carlos and his head trader were fired.

In the near future, the Carlos story will be repeated. Many investors will realize that they have been "fooled by randomness". The ability to cut losses and, for a small group of players, the ability to profit from a decline will become desirable traits in money managers. Skill is about to become extremely important.



**"It does not matter how frequently something succeeds if failure is too costly to bear."  
Taleb**

## WHAT DID THEY SAY AT THE TOP? AND TODAY...?

In the April and May issue we explored statements made in 2000 by various leaders in the financial world. In the April, we heard from those who were bullish, and in May, we heard from those who were bearish. By 2002, it was quite apparent whose views we should have listened to.

Today, the same pundits are putting out their opinions to the public. Below, I have chosen a couple noteworthy bullish outlooks. Remember, bullish and bearish interpretations of the markets, is more than an intellectual debate. Like the period of 2000—2002 revealed, passively following certain views comes with a cost. Volatility cannot always be explained as temporary loss.

*Abbey Cohen (Chief Investment Strategist, Goldman Sachs) "Wall Street's Crystal Ball Reveals an Overcast 2005" January 2, 2005. "We've been fortunate in that consumers have done what they do best, and that is consume. But that has been followed up by businesses being willing to spend. As businesses start unloading all the extra cash sitting on their balance sheets in 2005, job growth should pick up."*

She gave a 2005 year end price target of 11,800 on the Dow and 1325 on the SP500. The DJIA was 10,783 and the SP500 was 1,211 at the end of December '04. As of June 30th, 2005, the DJIA closed at 10,274 and the SP500 at 1,191.

*Alan Greenspan (Head of the Federal Reserve) Testimony before the Joint Economic Committee, U.S. Congress on June 9, 2005.*

"The most recent data support the view that the soft readings on the economy observed in the early spring were not presaging a more-serious slowdown in the pace of the activity. Consumer spending firmed again, and indicators of business investment became somewhat more upbeat.

Although a 'bubble' in home prices for the nation as a whole does not appear likely, there do appear to be, at a minimum, signs of froth in some local markets where home prices seem to have risen to unsustainable levels. Although we certainly cannot rule out home price declines, especially in some local markets, these declines, were they to occur, likely would not have substantial macroeconomic implications.

In conclusion, Mr. Chairman, despite some of the risks that I have highlighted, the U.S. economy seems to be on a reasonably firm footing, and underlying inflation remains contained."

In July we will look at the bears. In the meantime, consider these words by Dr. Stephen Roach of Morgan Stanley on June 27, 2005. "Steeped in denial, the Fed is trying to deflect attention from its role in this sad state of affairs..." See the full article, "The Endgame", under Education/Weekly on our site.

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Although we certainly cannot rule out home price declines.....these declines, were they to occur, likely would not have substantial macroeconomic implications."

Alan Greenspan

June 9, 2005

**TECHNICAL PICTURES – INDEXING AND RISK**

We are often told that if we will just take the middle of the road and buy the index that we will profit over the long run. If you had the good fortune of beginning your investing career in 1980, congratulations. Fate has been good to you.

But what if the next decade is a repeat of the 1960's or the 1970's, or worse. Buying an all bond "index" in the 60's would have lost investors about 7% by the end of the decade, whereas with a stock "index fund" we would have almost broke even. In the 70's the range was between a loss of about 2% and, again, almost breaking even.

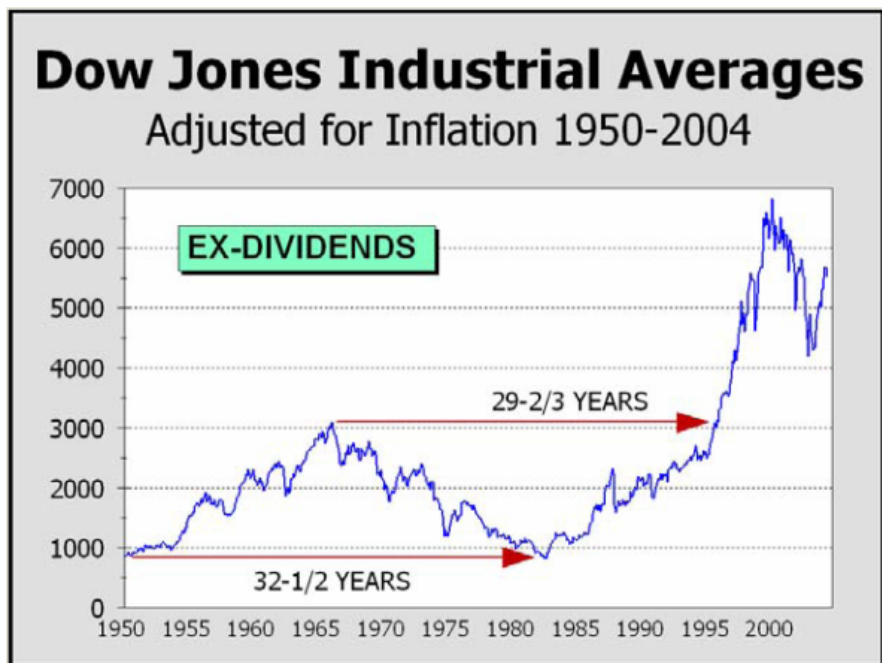
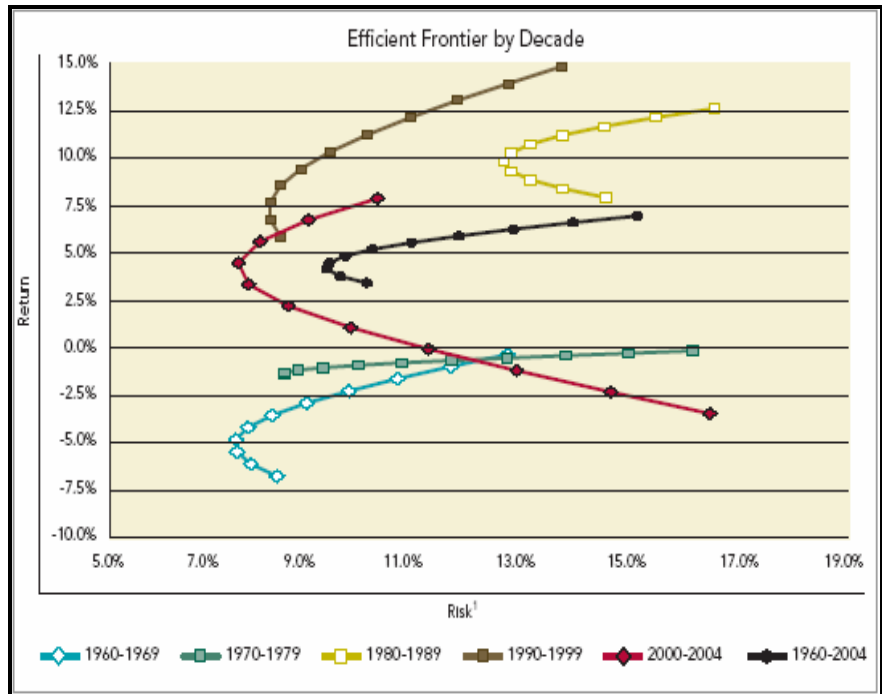
If we consider the effects of inflation and other timeframes, the results are even worse.

Aside from the two 30 year periods pointed out as breakeven points on this chart, there are multiple years in which "indexing" would have lost money.

True, if we had started investing in 1950 and gotten out in 1965, we would have done well. However, what Wall Street firm was saying sell at the end of the go-go years. Who, other than players like Buffett and Graham, were saying that opportunities were very hard to find in that overpriced market.

If we began investing in 1965 would we have continued to invest more money into our long term strategy as the effects of the markets and inflation had us at a loss even 20 years later?

The point is that indexing is unwittingly considered a low risk investment strategy, while active trading is considered aggressive or even speculative. We look only at the wealth generated over the last 20 years, and lose sight of the risk that truly exist. Indexing seems terribly easy and therefore more palatable. While my arguments require more thought, history has shown, and may yet again show, buy and hold can prove very costly over long term periods.



## HISTORICAL — WHEN GENIUSES FORGOT NATURAL LAW

Money and pride are almost synonymous. “I work with the most prestigious...I have made over \_\_\_\_ in the last three years...these guys work with some of the richest people.” Winning in the money game can build an huge ego and can lead some of the “smartest” in the game to think they can overcome natural, market forces. In 1998, the financial system underwent enormous pressure and investors lost billions in less than 60 days. It was dismissed by many as a fluke. The details tell another story.

The triggering event was the fall of Long Term Capital Management. While you can learn more from listening to my book review, “When Genius Failed” by Roger Lowenstein on my website, I would encourage any serious investor to read this book.

LCTM comprised some of the brightest math minds in the money game. John Meriwether assembled the group in 1977 to run the Arbitrage Group at Salomon Brothers. These men rose to world acclaim during two major world changes: the massive decline in interest rates of the 80’s and 90’s and the growth of the PC. Personal computers gave them the ability to calculate very complicated math equations involved in derivatives trading, while large moves in interest rates gave them the ability to make hefty bets in bonds.

While this short article will not do justice to this event, the most visible lesson to be learned from this moment in history is that human nature and the nature of markets have not changed. When men forget their own biases and the laws of nature, the consequences can prove quiet severe.

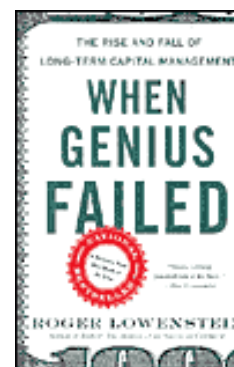
During the 1980’s, the Arbitrage Group at Salomon Brothers produced very large returns with little losses. This group, consisting of PhD’s in math from Harvard and MIT, went on to form Long Term Capital Management in 1994. Their large returns and small drawdowns from 1994—1997 made them appear invincible. And by 1997, as they were taking on more and more money, they began to believe it too. They greatly increased their use of leverage and expanded their trading into markets in which they had no expertise.

Finally, in 1998 their bond positions in the Russian and certain Asian markets were so big, they practically were the market. When the Russian and Asian markets and economies collapsed under the weight of massive monetary inflation, LCTM couldn’t move. With the size of their positions and their inability to unwind highly leveraged positions without suffering heavy losses, their losses began to mount. At times the losses hit \$145 million a day. Eventually, the Feds interceded asking several large Wall Street firms to resolve this matter by putting together their own bailout package. When even this did not stop the hemorrhaging, Greenspan cut rates quickly to “add liquidity.”

The original investors had seen a gain of 82% in just 4 years. However, those getting in at the top were crushed as the partnership units plunged 92% in less than a year.

What the men at the helm and those who invested in Long Term Capital Management ignored, was the power of their own egos. We would do well in 2005 to consider these words spoken over 3,000 year ago. “Pride comes before destruction, and a haughty spirit before a fall.” (Proverbs 16:18 NKJV)

**“Pride comes before destruction and a haughty spirit before a fall.”  
Solomon (app. 1,000 BC)**



## EDITORIALS — INVESTING DURING DEFLATION

A reader recently asked, “How should we as individuals be preparing for the danger of long-lasting deflation?”

Since most of us have only experienced inflation and inflationary effects on our investments, in order to understand the ramifications of deflation, we must read history and look to the second largest economy in the world. That is to say, we need to review the America’s Great Depression and Japan since 1989. Though space does not permit a full explanation here, read my articles “The Great Inflation Illusion” and “A High Wall”, found in the Archives section of [www.safehaven.com](http://www.safehaven.com) under Doug Wakefield.

If believe as I do, that history teaches that rampant credit leads to a false boom followed by a bust, then read on.

There are several different types of tools that can help investors during declining markets. I will touch on four possibilities here.

1. **Short Only Managers** — These are managers who specialize in shorting the markets. As of May 2005 the Strunk Short Index has only 10 managers listed. Compare that to the existence of 7,993 mutual funds as reported by the Investment Company Institute in April 2005. Because of the history of short selling and the buy and hold bias in the industry, most investors do not even know this option exists.
2. **Inverse Funds and Bear Market Funds** — There are three mutual funds companies that cater to traders. Each of them have index funds as well as inverse index funds. These tools give the investor the possibility of profiting from a declining market. Inverse index funds, which represent less than .5% of the industry, are designed to do perform opposite of a regular index fund.
3. **Long/Short Trading Managers** — These are not necessarily hedge funds. Our screening process and that of other screening firms that we use, have allowed us to identify an extremely small group that can trade either index and inverse index funds or buy and short Exchange Traded Funds.
4. **Hedge Funds** — These tools can only be used by accredited investors. The Hedge Fund industry has grown so fast since 2000, there are bound to be strategies that rack up large losses in the next two years. However, it will not be because all hedge funds are bad investments, but because many investors are pouring into the strategies that performed well yesterday. If you are using these tools, you really need a hedge fund consultant (which we are not) who has the staff, technology, and insight to find the few hedge funds that have prepared well for the markets ahead.

As the bear continues, realize that **there are ways to profit from a decline.**



Can we both win?

**The Strunk Short Index shows only 10 managers as of May 2005, while the Investment Company Institute shows 7,993 mutual funds as of April of the same year.**

Disclaimer— Market risks today make it essential that one not make impulsive decisions. One would do well to read and learn and ask a lot of questions before using any tool. Next month we will examine risk in “safe” alternatives to investing.

Encourage anyone you know to check out [www.bestmindsinc.com](http://www.bestmindsinc.com)

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### **The Mission:**

**To look to the best minds in the world of finance and economics to seek a direction for our clients and to be a true advocate to those who will listen.**

**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**

### **RISK — COUCH POTATOES BEWARE**

As you can probably tell by now, I am greatly concerned by conventional definitions of risk. There seems an almost total lack of thought regarding why a particular tool is considered risky or safe. If one were to tell us to invest in an S&P500 index fund, this would be considered moderate risk. If one were to tell us to invest in an FDIC insured bank account, this would be considered low risk. Yet, if one were to tell us to invest in an inverse fund that sought to make a return opposite the market, this would be considered aggressive or even speculative.

Now let's look at these options in a bear market and a recession. If the S&P500 performs like it did from 1931 to 1951, we would see a 1% average annual return. Compare this to the period from 1980 to 2000 where the S&P500 would have produced a 12% average return.\* So, can history guide our future investment decisions or are we all left to random chance?

How about the FDIC CD. While this may be low risk based on volatility, has history shown CDs to be a tool to help us grow our money? Is there a possibility that our purchasing power could be outpaced by inflation? Could bank lending practices ever have an effect on my money or can the FDIC always bail them out?

An inverse fund would certainly be very speculative, and even damaging, if the markets behaved like they did in the 50's or the 90's. But what if the markets perform like they did from 1929—1933 or 2000—2002? Each of these tools entails certain levels of risk. None by itself is the holy grail. However, the promotion of a “don't think; just hold on for the ride” investment strategy, in my opinion, is downright reckless.

(\* The S&P500 information is stated in nominal returns and does not include dividends nor is it inflation adjusted. A fantastic chart on the history of S&P500 returns was compiled by Ed Easterling of Crestmont Research. Download it from the Research section of our website. One should not invest in any mutual fund without reading it's prospectus. If using a trading manager, one should review their ADV Part II)