

OUTSIDE THE BELT-STREET

MAY 2005

INSIDE THIS ISSUE:

NORMAL...OR NOT?	1
CURRENT VIEW OF THE STORM	2
THE EMOTIONAL FACTOR	3
DISTORTIONS	4
TECHNICAL PICTURES	5
A LESSON FROM HISTORY	6
EDITORIALS	7

SPECIAL POINTS OF INTEREST:

- **US Economic (Un)Health**
- **Signs of a Mania**
- **Self is Never Neutral**
- **2000: Who said what**
- **A Historic Look at Real Estate Lending**
- **How to Decide What to Buy**

SITUATION NORMAL...OR NOT?

You go to the doctor. After multiple test, he proceeds to tell you that your heart is in terrible shape, your blood pressure and cholesterol are off the charts, your 100 pounds overweight, and your blood work just came back with an extremely high white count revealing that you're fighting off a severe infection, but not to worry, the life expectancy of an average person your age is so many more years.

Would you be contented and go along your merry way or would you be more likely to seek a second opinion? Me, personally—I'm seeking another doctor.

Okay, so how about the health of the US economy. We currently have the largest fiscal deficit in US History, the largest trade deficit in US history, the largest consumer debt in US history, the lowest savings ever recorded in US History, the weakest recovery in jobs since World War II, and the highest real estate prices in US history. But don't worry; look at the averages over the last 20 years. The markets consistently go up.

So, we go along our merry way and continue to buy the index.

Why do we respond so differently in the latter case than in the one presented earlier? It comes down to this: we do not want to even consider it. The implications scare us, so we content ourselves with the words of those who rationalize these major imbalances as nothing more than accounting issues. Understandably, we are comforted by believing that these are minor problems that can be remedied with the stroke of the pen rather than major issues we must act to counter.

The majority of the information we hear is based on buy and hold strategies, and thus has a bias towards up markets. This advice pays little attention to historical data and seeks to justify our current major imbalances. The answer is always, in one form or another, to index. Personally, I would rather seek a second opinion and know as much as possible from the study of history and in depth research of our existing situation.

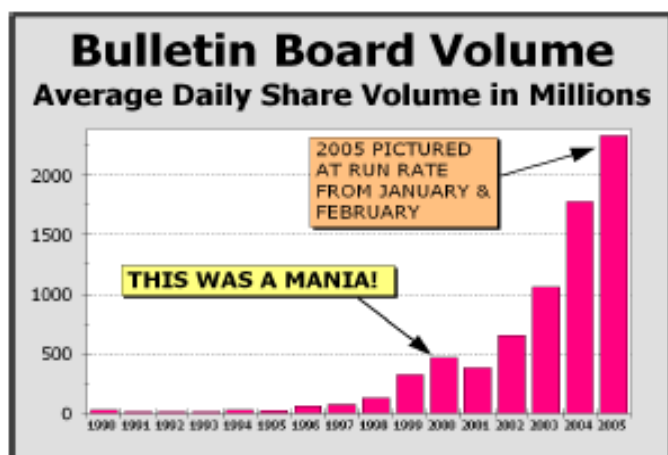
While some pools of money are so large that they, like aircraft carriers, cannot change course quickly, they should at least slow speed and change tack so as to miss the worst of the storm. For individuals, the lack of bureaucratic structure makes it easier to maneuver and to actually profit from the storm to come.

A CURRENT VIEW OF THE STORM

“There are no minimum quantitative standards which must be met by an issuer for its securities to be quoted on the OTCBB (Over the Counter Bulletin Board).”¹

In reading Alan Newman’s (www.cross-currents.net) monthly newsletter over the last eighteen months, I have found his uncommon insights into the workings of the market very helpful. One of the ways we can measure higher market risks is to observe increases in trading volume, in that these increases reflect manic public pre-occupation with the markets (See my review of Extraordinary Popular Delusions & the Madness of Crowds).² Add to this the risk incumbent to much smaller and less regulated bulletin board issuers, and we begin to grasp the scope of the problem.

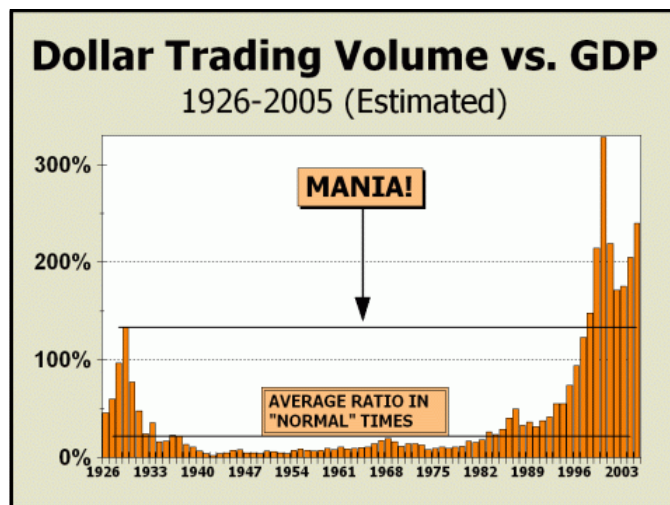
The amount of speculation as measured by trading activity in the cheapest stocks strongly suggest a pre-crash mania.



Ask yourself, “does the chart to the left look like a group of individuals who are prudently selecting companies based on long-term growth potential or a view of a mania before a crash?”

As explained in the Special Editions Parabolic Rises 2004 newsletter, a parabolic spike, by its nature, is not sustainable. In looking at the chart to the left, we see that share volume rose 370% from September 2004 through January 2005, alone.³

The chart to the right shows that current speculation is on par with, or in excess of, 1929. In the 1927, President Coolidge announced that America had entered a “new era” of permanent prosperity and permanently rising stock prices.⁴ Today, after the largest and longest bull market in US History and the Federal Reserve cutting interest rates and flooding credit, most investors still consider our “new era” impregnable. However, based on the laws of nature and science and the lessons of history, gravity will set in and we will experience a fall just like the fall that occurred after 1929.



1. www.otcbb.com/investorinformation/investorinfo.stm
2. www.bestmindsinc.com/bookreview.html
3. www.cross-currents.net U.S. Stock Market Outlook for March 28, 2005. Alan Newman
4. [A History of Money and Banking in the United States](#), Murray N. Rothbard, pg. 420

THE EMOTIONAL FACTOR — SELF IS NEVER NEUTRAL

Are we neutral beings or do we form certain biases over our lifetimes? While the answer is all too obvious, amazingly, professional and individual investors alike do not take this into account as we make our investment decisions. But why would we, since this is not taught, or even considered, in most schools of finance?

So, as we build on last month's article on crowd behavior, let's see what we can add in order to help us overcome certain obstacles in our thinking and ultimately become better investors.

First, the neo-classical financial theories teach us that man is rational and that we all have the same amount of information. Thus, we cannot beat the collective reasoning of other investors and cannot beat the markets. But think about it. If we all had the same level of information and we were all rational, why would anyone ever pay more for a security than the next person or sell it for any less? In other words, if we all had the same information and we were all perfectly rational beings, there would be no markets because we would all be on the same side of the trade.

Our problem is not that we act rationally all the time, but rather that we rationalize our actions. Plainly, two of our most natural instincts are to seek personal comfort and the respect of others. However, since history has shown that the greatest investors are prepared to invest against the crowd, if we are to be successful, we must overcome our natural tendencies.

Then, the broader experience of the last 20 years reinforces our beliefs. Sure, 2000 to 2002 were rough times, but things got back to normal. In 2003, stocks soared and money was easy to make. 2004 was a little rougher, but the downturn was just a correction and the gains, though slight, served to calm us. Now, in 2005, as we look at our statements, we rationalize that the losses we see are only temporary. We tell ourselves we're not headed into a bear market, this downturn won't be severe, and the markets always rebound so we've no need to alter our investment strategies. As Pascal said, "Ordinary people have the ability not to think about things that they do not want to think about."

Behavioral studies show that we evaluate what we are doing, not on absolutes, but based on how it relates to what others are doing. We tend to care a great deal about how society views our performance and measure our results accordingly. In fact, most money is managed based on relative performance to an index rather than absolute returns.

I realize it is hard to be critical of ourselves, however as the bear market moves forward, we must, at least, learn to be critical of our decisions. A test is at hand. One that will show who has benefited from luck and who has benefited from skill. In the end, losing less than the index is not the goal: making money is.



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have the ability
not to think
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Pascal**

WHAT DID THEY SAY AT THE TOP—REVISITED

Last month we looked at a few major figures in the world of money and what they were saying at the top of the markets in 2000. Encouragement, by their optimism, cost investors dearly by 2002. Yet there were others who shouted, “FIRE!” **before** we went over the top. This article will review a few of these individuals. Their careers have been market by staunch independence, and they do not run with the herd. While one could argue that I am just taking isolated comments to make a point, you will notice a recurring pattern of longevity in the industry within the members of this group.

Richard Russell (market commentary since 1958)—Dow Theory Letters, September 1999. In this issue, he told his readers that a sell signal had been issued based on Dow Theory and that he feared that the oncoming bear market might be a drawn-out grinding affair. “The Fed and the politicians are committed to fighting the bear tooth and nail. Their fighting will serve to extend the bear market far beyond what might ordinarily be expected.”

Dr. Marc Faber (economist and investment advisor in Asia for over 25 years)—U.S. Bear Markets—Phase One, August 1999. “The first phase of the bear market is in full force. But it is well hidden. The mood is extremely optimistic. Such is the case in the first phase of a bear market: negative news is dismissed as irrelevant and immaterial.”

David Tice (President of Behind the Numbers, a Sell Side Advisory Firm, and portfolio manager specializing in shorting)—On Wall Street, October 1999. “As the symposium’s [The Credit Bubble and its Aftermath, September 21, 1999] title suggest, the focus was on the credit bubble in our country. We adopted this theme because the stock market is not a mania in isolation, but a consequence of an economic bubble driven by expansive credit and lax monetary policy.”

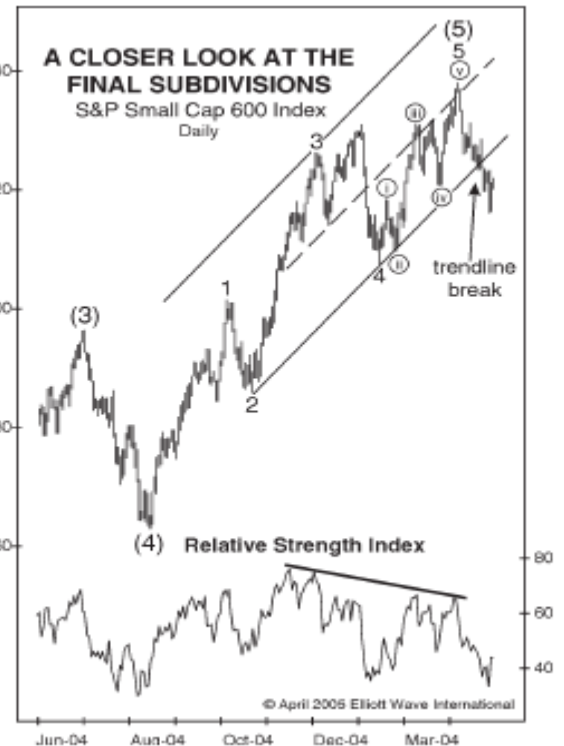
Dr. Kurt Richebacher (Austrian School of Economics economist providing advice for over 60 years)—The Richebacher Letter, February 2001. Bust. “For years we have been warning that this “bubble” and “bubble economy” will end like all their predecessors: in a devastating bust. Now the Fed is facing its greatest outstanding challenge in the whole postwar period, we think. Many believe that the U.S. economy may experience a sharp downward lurch, but thanks to rapid Fed easing, it is expected to be a brief, painless affair.”

With a roaring real estate market and the major indexes back up from 2002, investors now must ask, “So what are the experts saying today?”

In our next issue, we will explore what both groups of experts are saying since 2004. Are there lessons to learn? After 2000, now is not the time to take this question lightly.

“Money and credit expansion went exponential. In short, excesses went to unprecedented extremes.”
 Dr. Kurt Richebacher,
 The Richebacher Letter, February 2001.

TECHNICAL PICTURES – TOPPING PATTERNS



If you have been reading with us since summer of 2004, you have seen many pictures. These pictures reinforce the lack of sustainability of the bull market hypothesis. As you will notice from these chart, all stock markets are showing a topping pattern in March 2005.

Three of these charts were developed by www.elliottwave.com. The chart in the bottom left hand corner comes from Dr. Robert McHugh at www.technicalindicatorindex.com. Information regarding their services can be obtained at their sites.

REAL ESTATE LENDING—HOW MUCH IS TOO MUCH?

In 2004, fully thirty-five percent of our nations real estate lending came from interest only loans. Since I have written about the huge boom in real estate lending for over a year, I thought it would be interesting to approach the topic from a historic viewpoint.

If we journeyed back to 1864, the end of the Civil War, we'd see a much different attitude in our nation about real estate lending. The National Bank Act of the same year virtually prohibited lending with real estate as collateral.¹ Since it was very illiquid, real estate was not considered a suitable investment for bank deposits. Indeed, this rigid view toward lending with real estate as collateral proved to have its benefits. After the Panic of 1873 and the ensuing depression that lasted through 1877, as John Thompson was stepping down as president of First National Bank (which went on to become Citicorp), he reflected on the period through which he'd just come. "A bank which has no real estate, not a debt in the world, no law suits and plenty of cash need fear for nothing. I leave the First National sound as a nut and hope it may be kept so."²

With the establishment of the Federal Reserve in 1913, lending experienced its first boom. From 1914 to 1920 over 1700 new banks were established.³ Insurance companies also had an abundance of money for real estate loans. With the advent of state and federal cooperative banks and the liberalization of real estate lending under Federal Reserve Act, our largely agrarian population assumed the majority of this debt. While lending standards did soften during the roaring 20's, bankers still required borrowers to have at least 40% equity against mortgage debts.⁴

As the merger of AOL and Time Warner, in March of 2000, signaled the top of a mania, so also did the establishment of the New York Real Estate Securities Exchange in the ominous month of October, 1929. The Chrysler Building 6% issue revealed that bonds too participated in the crash. In two years, from early 1930, their price fell from 95 to 38 cents per dollar.⁵

After the Crash, bankers shifted from too much lending to too little. In 1933, Frank Sisson, president of the American Bankers Association, feeling that government bailouts would open the door to more aggressive lending, was actually against the founding of the FDIC.⁶

And surely Sisson was right. In our lifetime, we have seen the Federal Reserve bail out Penn Central in 1969, our major American banks from the Latin American Crisis in 1982, the Continental Illinois in 1984, and FSLIC, better known as the Keating Five, in 1990. With the issues currently facing Fannie Mae, second only to the US Treasury in lending, what will happen next?

The National Banking Act of 1864 virtually prohibited banks from lending with real estate as collateral.

EDITORIALS—WHAT HAVE YOU DONE FOR ME LATELY?

As we become more aware of the bear market setting in and the economy slowing down, I encourage you to email me with any questions about the “money game” that you would like addressed. I will select various and recurring questions and answer them in this editorial section. I hope you will be open and candid. Many of us have questions and now is the time to ask them.

Understandably, most investors look to recent performance as one of the initial steps in choosing a manager. So the question becomes, in multiple forms:

“How has he [the manager] done lately?”

The trouble with this question is that we may be hiring a manager whose season for profitability is coming to an end. As such, there is little chance of the manager making those returns happen again.

In April, I spent two days in California at a conference co-sponsored by Altegris and John Mauldin. It was one of the best conferences I have ever attended. This bias, to depend too much on past returns, was discussed by Mark Finn, who owns Vantage Consulting and has spent years consulting Fortune 500 companies and large pension funds and analyzing trading systems.

He commented that his experience has shown that past performance was one of the most misused criteria in selecting investment managers. Behavioral studies show that we have a tendency to transfer past numbers into the future performance. If we start with the managers with the best numbers, then our sampling is skewed. We do not know whether the manager’s performance was based on luck or skill. Additionally, our focus on “good numbers” overlooks the a manger’s amount of experience . Experience indicates that the manager has successfully navigated more types of markets and is particularly important if the manager has traded through a bear.

Jon Sundt, president of Altegris, presented on the three criteria Altegris uses in seeking managers. They look for skill, opportunity, and size. The first thing to try to find is a manager that is highly skilled. It is very important to understand his trading systems and the reasoning behind his trades. Next, the manager’s opportunity should still be in front of him. Being well positioned for what lies ahead means that he may not have great recent performance numbers. Finally, if the manager has a smaller amount under management, then he can get into and out of markets with much greater flexibility, adding to his profitability.

If you would like to learn more from these great speakers, check out the April 29th and May 6th newsletters at John Mauldin’s site www.2000wave.com. Excerpts can be found under “Previous Articles” and “Archives”. Looking at performance numbers, without understanding the opportunities (or pitfalls) that lie ahead, has lead many an investor to capital losses. Do not be one of them.



Did you pull a card?

“If you wait until a manager has ten years of good numbers, his opportunity may have passed. You may be taking great risk with that manager.”

Mark Finn,
Vantage Consulting

Encourage anyone you know to check out 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

WEBSITE

After numerous hours of work, our new website up and running. My hope is that each time you visit our site, your knowledge of the money game will increase and that you will understand the substantial risks investors are facing in various markets today. In John Piper's book, **Don't Waste Your Life**, he states that risk is caused by a lack of knowledge. I agree. My intention is to lower the risk of anyone who frequents www.bestmindsinc.com by the knowledge he or she gains. So, below I present a brief overview of our site:

WHO SAYS IRRATIONAL EXUBERANCE IS A ONE-TIME THING?



Home—The five questions presented are ones that we felt any investor would need to ask regarding the current investment environment and why we are set up as a fee-only investment advisory and consulting firm.

Services—Since many readers do not know which tools and managers are set up to profit from a long or secular bear market, our individual and institutional services are designed to constantly research and bring to light the best ideas we can find to steer investors through the storm.

Education—This is the main objective of our website. Without a grasp of why this is a major juncture in the history of financial markets, you will lack the desire to rebuild your investment tools and managers. Whether a quick article, excerpts from a book, or a thorough review of an economic issue, any investor will find something of benefit here.