

The Advantage Advisor

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Market Commentary:

There is a song from back in the 1980's that contains the line "Here I am standing in circles". That certainly is a good description of the financial markets over the past several weeks. While they have not been standing still, they have also not been making any real headway either - but believe it or not, that can be good news. While positive news items have not enabled the markets to break out of their current slump, neither have negative ones been able to push prices down to new lows. That is a good indicator that we may well have seen the bottom to this bear market.

However, just because we may have hit the bottom does not mean it is time to jump back in with both feet. Certainly there are bargains to be found, but we should expect to see continued strong volatility for the next several weeks before the trends can settle out and provide direction once again. The markets are still in the process of sorting out where the risk really lies, and what companies may surprise with bad news.

One example of a negative surprise was the current earnings release from General Electric, which came in almost 14% lower than expected. This was a major blow to the confidence of investors and GE shares dropped by almost 13% that day. Those kinds of misses by seemingly bullet-proof companies will keep the volatility high until at least this summer.

As of March 31st, the S&P-500 is down 15.5% from the high reached on October 9, 2007, while the tech heavy NASDAQ Composite and the small cap Russell 2000 Stock Index are both down 18.7%. There was hope that the technology sector

Market Statistics for March

<u>Market Index</u>	<u>Closing Price</u>	<u>% Change</u>
Dow Jones Industrial Average	12,263	-0.0%
S&P-500 Stock Index	1,323	-0.6%
Russell 2000 Stock Index	688	0.3%
Shearson Treasury Bond Index	15,853	0.9%
Dow Jones World Stock Index	273	-1.5%
Nasdaq Composite Index	2,279	0.3%

would begin to stabilize soon and lead the way back up, but that has yet to materialize. Because of the fear of a prolonged economic slowdown, consumer and businesses alike are scaling back their purchases, and that is keeping profits for tech companies down.

While the housing slowdown and fear of recession may be weighing heavily on the minds of consumers, one of the greatest weights on the bottom line for corporations has been the relentless rise in commodities prices, most notably crude oil and metals used in manufacturing. It remains unknown just how much of the rise in prices is due to actual increasing demand versus hedge fund speculation. Regardless of the cause, the impact on our economy and financial markets has been substantial.

Within our investment strategies, there has been little movement over the past month. We remain conservatively postured in all areas, and continue to hold a hedge against further market declines within our stock strategy. There have been some very encouraging signs in the Bond Strategy as the high yield market appears to be coming back to life once again. We still maintain that any recovery will begin to show somewhere in the summer months, probably the late summer. In the mean time, we will continue to watch carefully and be ready to move when the time is right.

The Economic Picture

At present, our indicators place us in a stage five economic environment. That is considered a pre-recessionary stage where economic growth is contracting, but has not yet turned negative. Without a doubt the Fed has let loose with virtually every tool at their disposal in order to mitigate the severity of any recession. The markets are still pricing in at least two more rate cuts, 1/4% in April and another 1/4% in June. That will drop the Fed Funds Rate to 1.75%. When you couple that with an expected inflation rate of around 2%, that gives us a negative Fed Funds Rate, which is about as stimulative as the Fed can possibly get.

The last time we saw a negative Fed Funds Rate was in 2002 to 2003, when Alan Greenspan took it all the way down to 1%. The resulting response in the fixed income markets was astounding - particularly in the higher risk corporate and high yield bond markets.

If you look at our table of economic indicators you will see that there has been a dramatic increase in the unemployment rate. This, combined with a substantial drop in the consumer confidence index is a troubling sign. The combination of those two things - rising unemployment and falling confidence - may well be enough to push us into a recession. The resounding question seems to be how bad, and for how long?

Unfortunately there is no way to answer that

Current Economic Position:
Stage 5 - Contraction

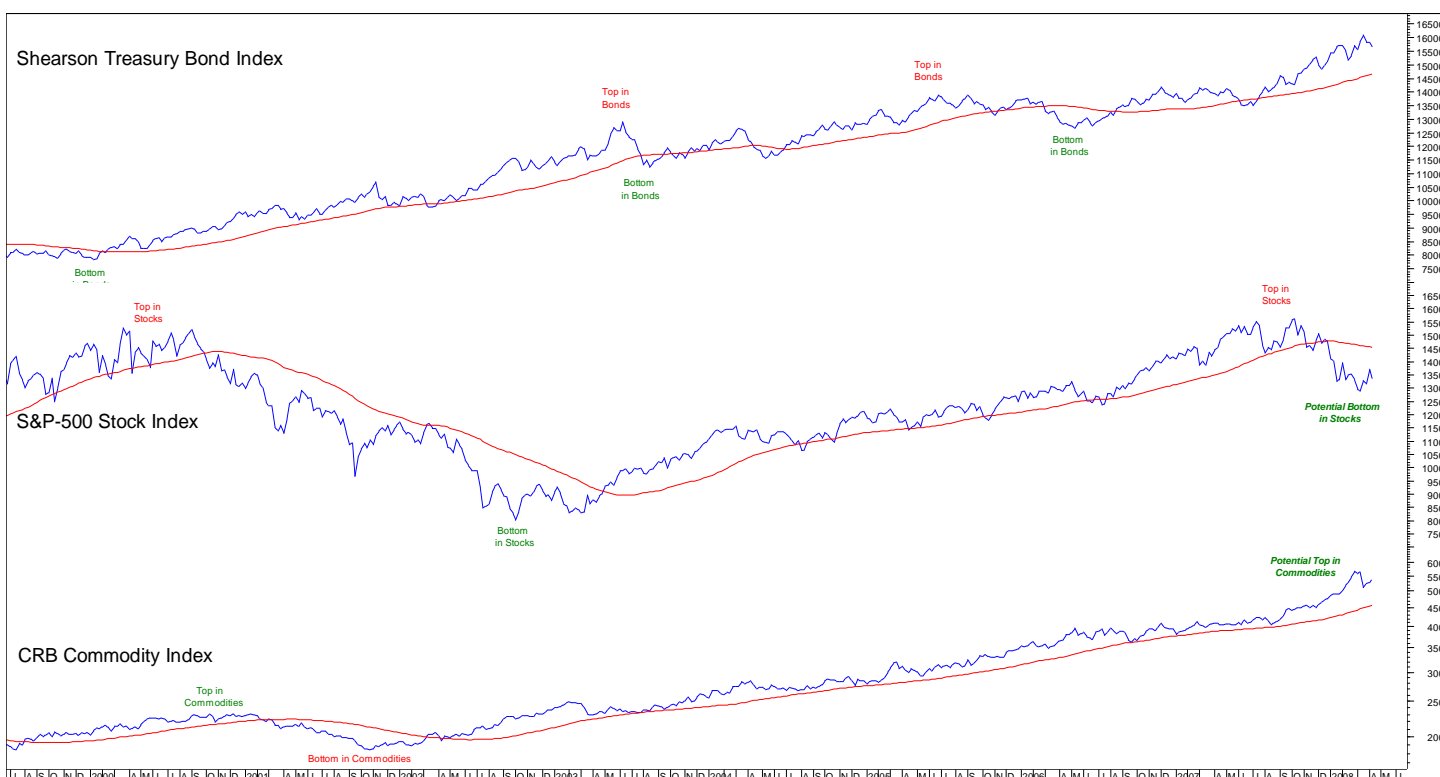
Economic Indicators

	Latest	Prior
Growth		
GDP	+0.6%	+0.6%
Productivity	+1.9%	+1.8%
Employment Cost Index	+0.8%	+0.8%
Capacity Utilization	80.9%	81.5%
Inflation		
Consumer Price Index	+0.0%	+0.4%
Core PCE Deflator	+0.1%	+0.3%↓
Implicit Price Deflator (GDP)	+2.4%	+2.7%↓
Sentiment		
Consumer Confidence Index	64.5	75.0
Unemployment Rate	+5.1%	+4.8%
Personal Income	+0.5%	+0.3%

↑=revised up, ↓=revised down

Source: Moody's Economy.com

with any real degree of certainty. But at the risk of sounding cliché, I do have to make the observation that this time is different. Normally when heading into a recession we see economic indicators at overheated levels, such as factory capacity utilization rates above 85% and inflation rates in the 5% and higher range. That simply is not the case here. That gives strong support to the argument that any recession will be shallow and relatively shorter than the historical average of 10 months. Also keep in mind that we may already be several months into it, so we may be nearer the end than the beginning.



Behavioral Finance: Is it impacting the way you look at investing?

In 2006, I published a series of articles dealing with the way that various behaviors can adversely affect our investing decisions. Given all the current market volatility and negative news reporting, it seemed like good time for a refresher on these bad behaviors so that we don't get caught up in them today.

Problem: Overconfidence

Overconfidence is a behavior that tempts us to play down the risks and potential pitfalls that really should be considered before making an investment. It leads us to think that bad things only happen to someone else, not to us, or that we really are so good that the normal risks don't apply to us. In his book "The Psychology of Investing", John Nofsinger gives this great example of overconfidence :

Question: Are you a good driver? Compared with the other drivers you encounter on the road, are you above average, average, or below average? How did you answer this question? If overconfidence were not involved, then one third of you would answer above average, one third would say average, and one third would say below average. However, people are overconfident in their abilities. In one published study, 82 percent of the sampled college students rated themselves above average in driving ability. Clearly many of them are mistaken.

One of the main causes of overconfidence in people is when they feel they have greater control over the outcome. Just as in the good driver example, people feel that when they have more control over a situation, they can force the outcome to be better. This became more and more of a problem during the late

1990's as online trading became commonplace. Investors began to feel that once they were making their own investment decisions and placing the trades themselves, they had a much greater chance of success. This led in the end to some devastating consequences as highly overconfident investors took greater and greater risks simply because they felt that they were in control.

Beyond potential losses, another outcome of overconfidence is the tendency to trade excessively. Overconfident investors tend to believe their decisions will always turn out to be highly profitable; therefore they tend to ignore things like transaction costs and tax consequences. By trading excessively, some investors spent more on transaction fees and other expenses than they made through the trades. Many also forgot

to factor in the costs of the capital gains taxes that would become due the next year and found themselves with large tax liability on April 15th!

Overconfident investors also tend to ignore the possibility of losing. After all, since they must be correct about their expectations, they simply **don't need to consider the potential losses**. But ignoring the potential losses does not make them go away. Professional investors understand that losses can and do happen. The key is to learn how to minimize those losses, and that cannot be

done if they are simply ignored.

Yet another dangerous aspect of overconfidence is bad behavior being reinforced through accidental successes. During the late 1990's, it seemed that all it took to make money was to pick any small internet startup company and throw all of your money into it. Investors who took this path often invested in companies selling what was referred to as 'vaporware' - a product that had not yet even been fully conceived let alone profitable. When the prices for those companies rose, it reinforced the belief in those investor's minds

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Problematic Financial Behaviors:

- ◆ Overconfidence
- ◆ The Illusion of Knowledge
- ◆ Mental Accounting
- ◆ Fear of Regret and Seeking Pride
- ◆ Reference Point
- ◆ Representativeness
- ◆ Familiarity
- ◆ Considering the Past
- ◆ House Money Effect
- ◆ Snake Bite Effect
- ◆ Endowment Effect

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that they had an innate ability to make good picks.

Problem: The Illusion of Knowledge

The illusion of knowledge is a behavior that leads directly to overconfidence, but deserves some individual attention itself. The illusion of knowledge is the tendency to believe that more information leads to greater accuracy in decision making. This can be a **very dangerous line of thinking in today's world** where the internet can provide more information than we could ever possibly hope to comprehend – and much of it dubious at best. Again, Nofsinger provides an excellent example:

...if I roll a fair, six sided die, what number do you think will come up, and how sure are you that you are right? Clearly, you can pick any number between one and six and have a one-sixth chance of being right. Now let me tell you that the last three rolls of the die have each produced the number four. I roll the die again. What number do you think will come up, and what is your chance of being right?

Different people may have a different reaction to that additional knowledge. Some may think that the number four is more likely to come up since it has so often before. Others might think that the number four has run its course and another number is due. In fact, if it is a fair die, there is no greater or lesser chance of the number four coming up than any other number each time the die is cast.

In investing, the illusion of knowledge comes from analyst opinions and reports, tips from friends or colleagues, and even internet chat rooms. It is crucial to remember that not all information provides a true and complete picture of any situation. The recent failures and bankruptcies of several high profile mortgage lenders testifies clearly to that. Most investors had no idea what they were really holding in those investments, simply because they were not given all of the

facts. Many were led to believe they were buying safe, low risk securities only to find they no longer had the ability to sell them because the market for them had simply vanished.

Another source of the illusion of knowledge is in **the academic world**. In 1994, a group of 'super investors' formed a hedge fund known as Long Term Capital Management. Lest you think I am making too much of the level of academic knowledge involved, two of the founding directors won the Nobel Prize in Economics in 1997 for their research in determining the value of stock options, known as the Black-Scholes options pricing model. These were the very men who made derivatives trading possible.

The fund did at first experience fantastic returns - almost 40% annually. But by late 1998, overconfidence on the part of these managers had led them to take massively over-leveraged positions in foreign government debt. When the Russian government defaulted on their bonds, those highly leveraged positions collapsed as well, leading to huge losses.

Eventually the Federal Reserve had to get involved, organizing a bail-out by a consortium of banks in order to avoid a wider collapse of the debt markets. All of those great minds were eventually led astray by their own knowledge and success. They failed to clearly see the risks involved in what they were doing, simply because they were supremely confident in their own abilities.

Overconfidence and the illusion of knowledge can lead us to take risks and make choices that would otherwise seem irrational. The key to avoiding those pitfalls is to ensure a disciplined, reasonable approach to investing. While we seek to get the best returns on our money, we always need to be aware that there is no way to totally eliminate risk. The key is to manage the level of risk that we take, and not to ignore it simply because **we don't want it to be there**. It is also critical to be sure that the sources of information we use are both credible and correct, so that we are not fooled by false knowledge.