

The Advantage Advisor

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Market Commentary:

Overall, January has been a fairly quiet month in the markets. With the exception of Treasury Bonds, the returns have been very good with relatively little volatility. The uptrend on the **S&P-500 Stock Index** has slowed considerably to a somewhat more reasonable 27% annual rate. However, even this slower rate would seem to be a bit ahead of things.

Overall, the picture as we enter 2007 is a very good one. Corporate balance sheets are very strong. Cash holdings among corporations are also near historic highs. This is important as companies will become pressed to put that excess cash to work either through expansion or through mergers and acquisitions. They might also pay the cash back out to shareholders in the form of higher dividends, but that is becoming less likely.

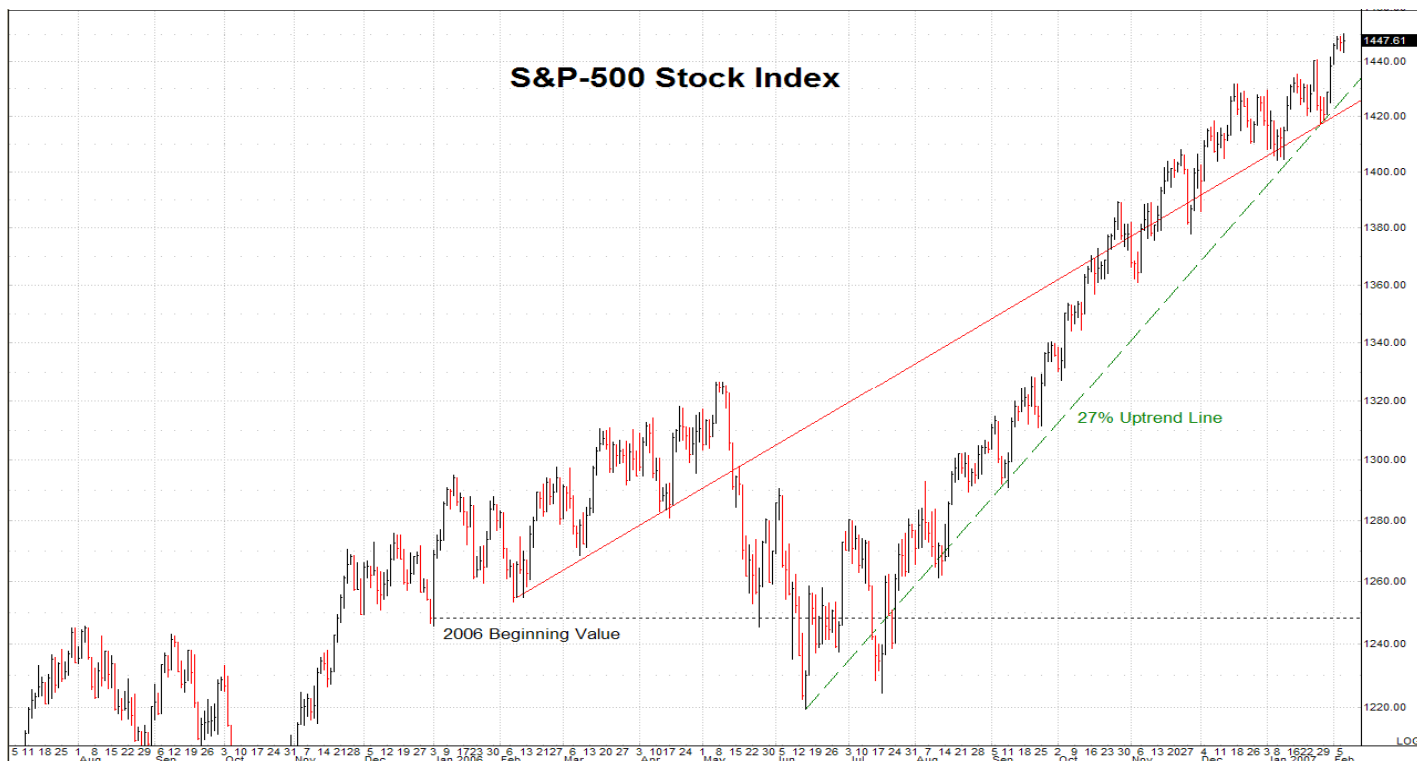
As we move through this third stage of our six stage economic model, we will begin to see more rotation in the types of stocks and bonds we hold. The reason for this is quite simple - we want to be where the money will be made, not where it has been made. To that end, we are anticipating further increasing the allocations to large cap

Market Index	Closing Price	% Change
Dow Jones Industrial Average	12,622	1.27%
S&P-500 Stock Index	1,438	1.41%
Russell 2000 Stock Index	800	1.61%
Shearson Treasury Bond Index	13,718	-0.79%
Dow Jones World Stock Index	281	1.11%
Nasdaq Composite Index	2,464	2.01%

growth stocks, technology stocks, and some additional international diversification.

Over the past several months, our investment strategies have significantly outperformed their respective market benchmarks. This shows that we are in the right place at present. It is likely that any changes in allocation will take place over time - say the next few months as opposed to next week. This is due mainly to the slower growth in the broad economy.

Because we have seen such a strong push in stocks over the past several months, a pause at this time would not be unusual - or even unwelcome. However, steady, solid gains such as we saw in January are always welcome.



The Economic Picture

The chart below is our familiar trio of market indices that aid in identifying the economic stage we are presently facing. Right now, all three of our indices are above their 12 month moving averages, which identifies the present as a stage three economy. Stage three is a growth stage, where strong gains can be realized in most of the major market sectors. A stage three environment generally begins with slow growth and gradually increases speed to much stronger levels.

One of the main characteristics of a stage three economy is the presence of consistent GDP growth with low inflationary pressures. Of course I have been writing for some time that inflation is not a problem at present, as both the reports and expectations have been well contained. The latest GDP report, however, was almost too good to be true. Headline growth was expected to come in at the 3.0% level, but instead posted a far stronger 3.5% growth. In addition, the implicit price deflator, a measure of inflation, dropped back to 1.5% from the 1.9% level in the 3rd quarter and 3.3% in the 2nd quarter.

Adding even more positives to the mix was the announcement following the FOMC meeting on January 31st. In it, the Fed held interest rates steady as expected, but also loosened the language regarding inflationary and housing market concerns. Also of note was

Current Economic Position: Stage 3—Growth

Economic Indicators

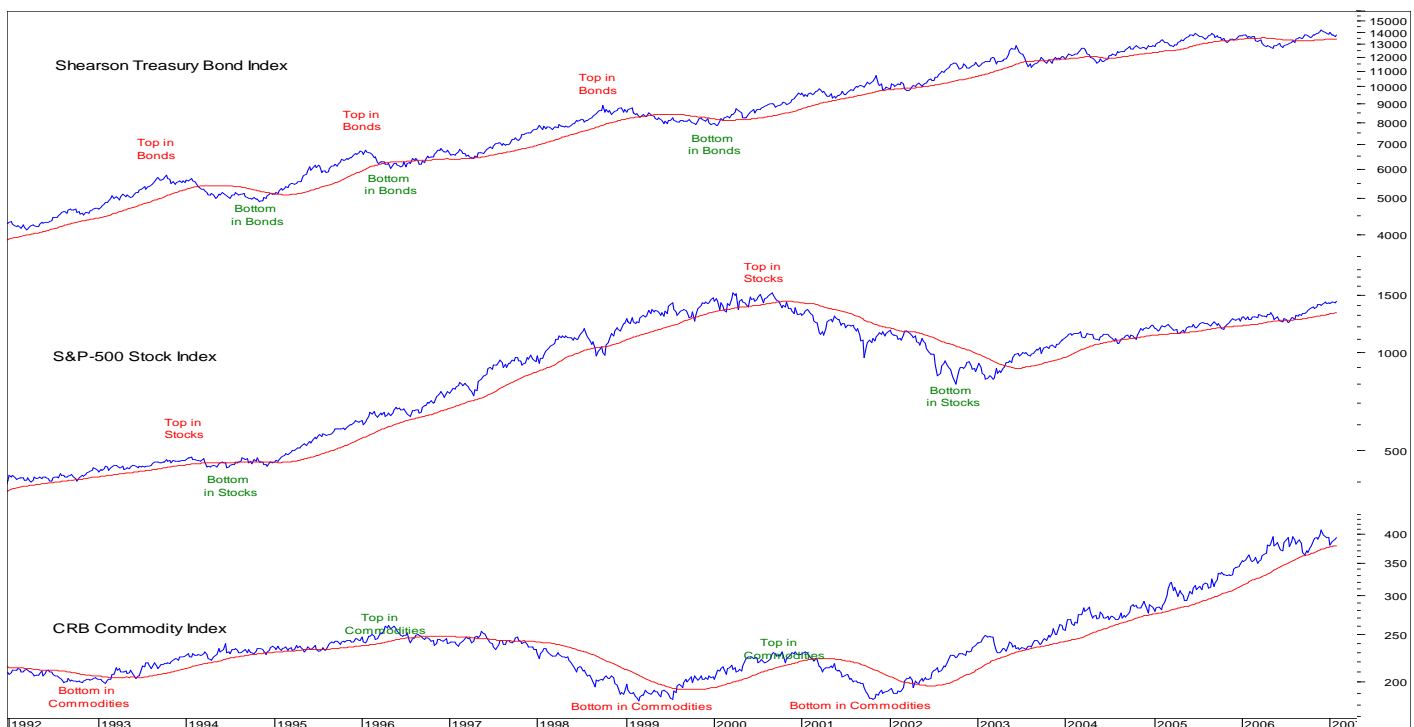
	Latest	Prior
Growth		
GDP	+3.5%	+2.0%
Productivity	+0.2%	+1.2%
Employment Cost Index	+0.8%	+1.0%
Capacity Utilization	81.8%	81.6%↓
Inflation		
Consumer Price Index	+0.5%	- 0.0%
PCE Deflator	+0.4%	- 0.0%
Implicit Price Deflator (GDP)	+1.5%	+1.9%
Sentiment		
Consumer Confidence Index	110.3	110.0↑
Unemployment Rate	+4.6%	+4.5%
Personal Income	+0.5%	+0.3%

↑=revised up, ↓=revised down

Source: Moody's Economy.com

the fact that the decision to hold rates steady was unanimous. This is a good sign as the past several votes had some still pushing for rates to go higher.

The only bad news is that expectations for a drop in interest rates during the first half of the year have fallen essentially to zero. The good news is that expectations for an increase in rates remain at zero as well. Even a stable interest rate environment provides a fertile backdrop for growth so long as inflationary concerns remain in check. This is a very good environment for stocks and bonds alike to provide solid returns.



Sources for Data: Investor's Fast Track

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

This month marks the final installment in our series on behavioral finance. The last three items in our list of problematic behaviors are what I would refer to as the three negative effects. They are the House Money Effect, the Snake Bite Effect, and the Endowment Effect. The three of them are very closely related, and so we will consider the three together.

Problem: The Three Negative Effects

Of all of the behaviors we have studied, the three negative effects are by far the most reactionary. They are born more out of instinct than anything else. What is truly amazing about these three effects is that most people who are guilty of them don't even realize it.

The first of the three is the House Money Effect. This was given its name because of the similarity in thinking to gambling. Consider a person who takes a seat at a blackjack table. He wins a few hands early on and feels very good about his luck. He pockets his original seed money and then begins to play only with his winnings, also known as the 'house money'. The problem here is that this individual begins to take risks that he never would have with his original cash. Note carefully that nothing fundamentally has really changed. All of the money is truly his and he is still sitting at the same table, but still his behavior pattern has changed. If in the end he loses it all, he can play it off and say "It was only the house money". This type of behavior

is seen quite often in investing, and it can really be one of the most damaging in terms of maximizing our future wealth.

The second effect is the Snake Bite Effect. Everyone has experiences that cause them to become suddenly more cautious than they normally would. The saying "fool me once shame on you, fool me twice shame on me" is good description of this behavior pattern. An investor may put their money into a stock that through unexpected and

unanticipated circumstances suddenly realized a large loss. This investor now runs the risk of being overly cautious with their next investment in an effort to avoid that same feeling of loss. By doing so, they may well compound the loss by diminishing any future returns.

The third effect is known as the Endowment Effect. This effect occurs most often when someone inherits an investment, but can also occur as a result of a merger or corporate spin-off. In any

case, the person receives something from an outside source, and has an unexplainable attachment to the item. Many times the attachment is due to the value that a previous owner had placed on the item. Other times, it is a result of having received something as a gift and not wanting to part with it.

It is not hard to imagine a person who receives a gift of an old car from a loved one that has died. The person who received the car may be unwilling to part with it at a reasonable price simply because of the emotional attachment to the vehicle. In the end, the person may never be able to

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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(Behavioral Finance, continued from page 3)

bring themselves to sell the car, and therefore never realizes the value of it. The same can easily be true of any such gift.

In all three of these effects, the resulting problems are very similar. Each of them causes us to act in a manner different from how we normally would. For example, the House Money Effect causes us to take on excessive risk. This can easily lead to losses that we would not otherwise have faced. The reverse is true of the Snake Bite Effect. This effect causes us to alter our behavior so that we become too cautious and thereby miss out on gains that we would otherwise have captured. The Endowment Effect is a sort of hybrid of the first two. In the end, it causes us to hold on to an asset far longer than we should and thus realize losses or forego the gains that we would otherwise have made. It is often difficult to realize just when these effects have a hold on our behavior. However, it is important to be aware of them in order to ensure we are making the correct decisions where our wealth is concerned.

Throughout this series, we have looked at different patterns of behavior that negatively impact our investment making decisions. Profitable investing is not an easy task, and in many ways it runs counter to our own nature as emotional human beings. Studying behavioral finance helps us to understand where the problems lie, and also how we can counter those limiting behaviors.