

# The Advantage Advisor

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## Market Commentary:

The financial markets continue to trade with a definite negative sentiment even in spite of stable economic fundamentals. The exceptionally volatile nature of the trading over the past few weeks continues to point to an inherent lack of conviction in the future direction of stock prices. Whenever investors are uncertain about the direction of the trend, the default position is to become defensive. Because of this, buyers wait on the sidelines while sellers drive the prices further down until the buyers just can't contain themselves any longer.

As a result, the stocks markets are now languishing in bear market territory, meaning they have fallen at least 20% from their most recent highs. The good news is that this seems to have been a psychological objective that had to be reached in the minds of many investors before they were willing to begin buying once again.

Our overall strategy at this time is to hold positions with our portfolios that limit downside losses while still maintaining exposure to those stocks and sectors which will be the initial beneficiaries of the pending turnaround. For example, during the first half of 2008, the S&P-500 Stock Index fell by 12.8%. Within our investment strategies we are holding funds whose first half performance was substantially better, such as MDLTX (+8.3%), TAGRX (+7.5%), MMUFX (-1.9%), and AMAGX (-5.3%). Not all of them are positive, but every one of them did substantially outperform the broad market. The same cannot be said even for Warren Buffett, whose first half performance was actually *worse* than the S&P-500 (BRK, -14.7%).

The rhetoric in the news is certainly negative right now. This owes mostly to the upcoming election and the fact that every bit of news has become political fodder. While this market is down, it is certainly not the worst we have seen - nor is it even close. Just seven years ago it seemed that the world would never be the

### Market Statistics for June

Market Index	Closing Price	% Change
Dow Jones Industrial Average	11,350	-10.2%
S&P-500 Stock Index	1,280	-8.6%
Russell 2000 Stock Index	690	-7.8%
Shearson Treasury Bond Index	15,394	2.0%
Dow Jones World Stock Index	267	-8.3%
Nasdaq Composite Index	2,293	-9.1%

same after the dot-com bubble burst and the Towers fell in New York. But it was just a year ago when we broke through the old market highs. That was no small feat considering it was a worse bear market than the great depression itself! During the 1970's we saw the failure of more than 1,000 S&L's. Today, we have witnessed only a handful of such events, and the Fed's current watch list of troubled banks numbers less than 100.

I'm not suggesting that those prior periods were easy to get through, only that we did get through them and the markets then moved ahead to reach new highs. There is no reason to doubt that we will get through this period as well. The key is to maintain our strategy of limiting losses while maintaining readiness for the recovery. And remember that regardless of your news source, right now everything is political - and a little skepticism can be a good thing.

## Special Focus: Just How Overvalued Are Home Prices?

Determining just how much home prices have changed over the long term is actually a rather difficult proposition. We can create an index to measure the value of stocks or bonds over time because they trade on a consistent basis and each individual share of stock for the same company is essentially identical. In other words, my share of IBM stock is no more or less valuable than someone else's. Therefore, I don't have to put mine up for sale to find out how much it is worth, I can simply look to see what someone else's has sold for and know that

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# The Economic Picture

While our own six stage economic model suggests that we are in a contractionary phase, the broad economy, as measured by GDP growth, is still expanding. However, public sentiment is decidedly negative, and that can indeed lead to a downturn if it does not improve soon.

The major weights on our economy are the housing market and high energy and food costs. I have included a special focus article in this newsletter with regards to the housing market, so I won't spend any more time on it here. Instead, I would like to focus on the inflation situation that is being exacerbated by those high energy and food costs.

There has clearly developed a divergence between the measures of headline inflation (what we pay at the store) and core inflation (stripping out food and energy). Core inflation becomes a problem when it begins to rise and leads to wage inflation and rising unemployment. And while the unemployment rate has risen recently, it still remains below the 5.8% average that we experienced during the booming 1990's.

The problem is that higher energy and food prices act more like a tax on growth. Those higher gasoline prices mean that we spend more at the pump, and less on discretionary purchases. (Not that it had any effect on those lines at the Apple store waiting to get the next generation iPhone!) However, so long as core prices remain

Current Economic Position:  
Stage 5 - Contraction

## Economic Indicators

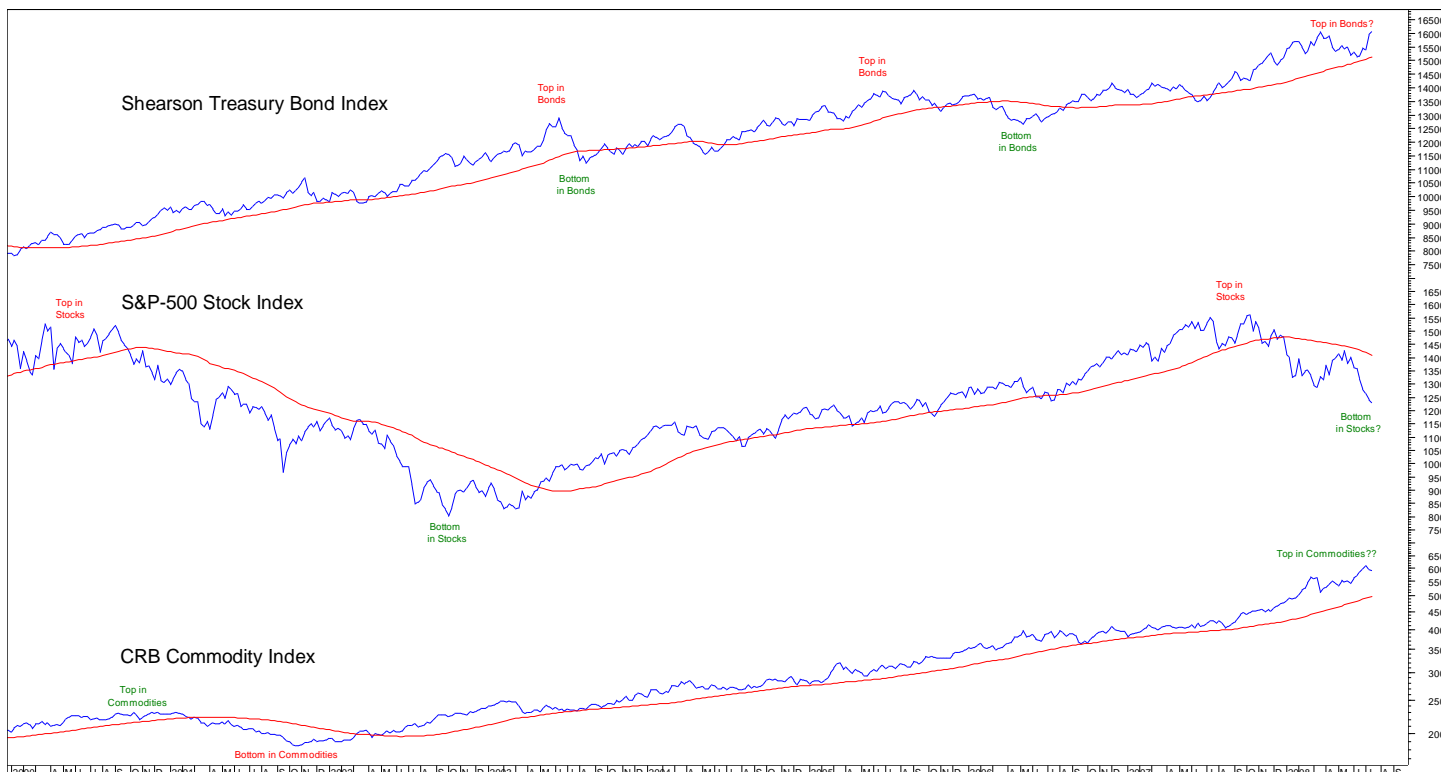
	Latest	Prior
<b>Growth</b>		
<b>GDP</b>	+1.0%↑	+0.6%
<b>Productivity</b>	+2.6%	+1.8%
<b>Employment Cost Index</b>	+0.7%	+0.8%
<b>Capacity Utilization</b>	79.4%	79.6%↓
<b>Inflation</b>		
<b>Consumer Price Index</b>	+0.6%	+0.2%
<b>Core PCE Deflator</b>	+0.1%	+0.1%
<b>Implicit Price Deflator (GDP)</b>	+2.7%↑	+2.4%
<b>Sentiment</b>		
<b>Consumer Confidence Index</b>	50.4	57.2
<b>Unemployment Rate</b>	+5.5%	+5.5%
<b>Personal Income</b>	+1.9%	+0.3%↑

↑=revised up, ↓=revised down

Source: Moody's Economy.com

contained, there is little that fiscal policy (i.e.: the Fed) can do to fix the problem. The answer to the dilemma lies in the markets own self-correcting mechanisms. Those higher energy prices will cause us to change our behavior in order to reduce our dependence on those items, and thereby lower demand and the prices.

So while the headline readings on growth remain positive, we will likely remain in a stage 5 - contraction phase until such time as food and energy prices come back into line. That means a conservative posture for investing with an eye for the downside risks.



Source for data: Investor's FastTrack

# 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.*

In this installment of our series on problematic financial behaviors, we will take a look at the idea of **Considering the Past**. We'll finish this series next month as we consider the last three related items together.

Problem: Considering the Past

In looking at the study of behavioral finance, we are mainly concerned with which factors outside the financial markets affect our investing. One of the greatest external factors is that of our own memory. It is amazing to see just how different our memories of an event may be from the actual outcome of that event. That is because memory is not simply a transcription of an event, but also a recording of the emotions that event brought into our lives.

There are really two areas to deal with when our memories of the past are involved. The first is whether the event was pleasurable or painful. The second is how we feel about the outcome of prior decisions—are we proud of those decisions or are we ashamed or saddened by them?

When it comes to any event, it is the *level* of pain or pleasure that affects us most. For example, if you buy a new car and then try to sell it within the first

few weeks, you will see a sizable loss due to the cost of depreciation. That would be a very painful event. However, if you buy the new car and then sell it several years later you will still lose the cost of depreciation, but it will be far less painful. Why is this? Because the loss was spread out over a longer timeframe.

The same is true with investments, and applies to pleasurable experiences as well. For instance, take a look at this example about two stocks from John Nofsinger's book, "The Psychology of Investing". The example talks about a biotechnology stock and a pharmaceutical stock that were purchased at the beginning of the year, both at the same price of \$100:

## 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

*"People feel better about experiences with a high pleasure peak and end. Consider a scenario in which the two stocks increased in price. The biotechnology stock increased to \$125 over the year. The pharmaceutical stock rose dramatically to \$120 at the end of the year. The memories of these events cause the investor to feel better about the pharmaceutical stock, even though it did not perform as well."*

The bottom line is many times we may make a poor choice simply because our memories fail to recall past experiences correctly. Most times, this causes us to take on excessive amounts of risk, which may well lead to disastrous consequences.

The other issue of memory concerns how we feel about an event that took place in the past. Psychologists call this a problem with cognitive dissonance. The idea here is that we adjust our recollection of past events to match with our own perceptions of ourselves. Cognitive dissonance works something like this: We all like to believe that we are good decision

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*(Behavioral Finance, Continued from page 3)*

makers. However, we have all made poor choices in the past that led to negative consequences. Because those poor decisions contradict our own positive self-image, our mind tends to ignore, downplay, or even forget the poor choice. In some cases we may even change our beliefs in order to be consistent with current decisions.

When it comes to our investments, we tend to reduce the impact of poor returns and accentuate good returns. By doing this, we end up overestimating both our own past returns and the potential future performance of our accounts. It is a very common occurrence for me to speak with people who consistently overestimate both the historical return for their own portfolio as well as that of the markets in general. This sets them up for disappointment on two levels. First, their recollection of their own performance may be unrealistically high and will likely never be replicated. Second, their over-estimation of **the market's performance can set them up for disappointment** when those lofty returns are not achieved. My job then becomes helping them revise those expectations to realistic levels that can be achieved and used to plan for the future.

This was an all too common occurrence during 2000, when the markets were just beginning their slide downward into the worst bear market since the depression. Investors still believed that the skyrocketing gains of those dot-com startups were still abundant. Even today this is happening in the real estate market as people set prices for their houses and land, yet see no interest at those levels. The pleasurable memory of rising home prices makes them want to believe it will continue to happen, even in the face of falling prices.

Memory can indeed be a tricky thing. It can make us act in ways that are detrimental to our long-term financial health. However, once we understand how it can affect us we can start to remove those inaccurate perceptions from the equation and become better investors.

*(Special Focus, Continued from page 1)*

mine is worth essentially the same. In market parlance this is known as the process of price discovery.

Unfortunately that is not the case when it comes to determining home values. In real estate there exists an almost limitless degree of variability among assets. Even two side-by-side townhomes can develop very different values over time based on their upkeep and fixtures. The effect becomes even more dramatic when we expand our search across differing metro areas, and even more when we look on a regional basis. In an effort to resolve this, economists Robert Schiller and Carl Case have developed the S&P/Case-Schiller Home Price Index. This index provides a measure of price appreciation across 20 different metro areas, based upon transactions which, as accurately as possible, **“trace the price path of a typical single-family home located in each metropolitan area.”**

The S&P/Case-Schiller Home Price Index has quickly become the most watched index used to determine the change in the housing market in the US today. According to that index, home prices across America have fallen by an average of 15.3% over the past twelve months – a disturbing thought to say the least. We are all well aware that home prices rose at a meteoric rate over the past decade, and are now falling as a result. However, what that headline fails to capture is whether or not home prices have pulled back enough to be considered fairly valued or if there are indeed further declines ahead.

**The first question that must be answered is: “Where do the index levels stand relative to historical returns for home values?”** Certainly we know that things went up much faster than “normal”, but just how much? Robert Schiller has done some additional work in the area of historical home values and has created a home price index that covers the period of 1890 to 2004 in America. While he admits that this index is far less accurate than the current S&P version, it still provides a good proxy for the long run level of home price appreciation.

According to Schiller, based upon that long-term index the average annual real (net of inflation) increase in home prices was a mere 0.40%. To most of us that is a shockingly low figure. But remember, this strips out the impact of inflation in order to look at the raw appreciation in the property alone. To see just how consistent this 0.40% increase was, I took a look at the 10 city composite for the S&P/C-S index from its start in 1987 through the end of 1999. Over that 13 year timeframe, the price index increased by 3.64% per year. At the same time, the US Consumer Price Index (CPI) rose at an average annual rate of 3.27% per year. The real gain in home values over that timeframe was therefore

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0.37%, which is right in line with the long-run 0.40% average increase. Note also that this sample was measured prior to the recent run up in prices. Therefore, it would appear that using 0.40% per year as a basis for determining the fair value of the price index is a valid starting point.

By applying that long-run real rate of increase in home prices, combined with historical readings of inflation, we can produce a good estimate of where home prices should be at this point in time. For a proxy of the rate of inflation we can use the US Consumer Price Index. The benefit of this index is that it not only shows the rate of inflation for the US as a whole, but can also be broken down for specific metropolitan areas which we can match up with the metro areas reported in the S&P/C-S Index.

Table 1, shown below, provides the results of my projection for the fair value of the housing price index, based upon the 0.4% real long run average increase as well as the actual nationwide inflation (CPI) for each year. As you can see, the forecast level for the Case-Schiller index is 129.88, representing an average gain of 3.19% per year. However, the

grim, however, because the numbers above do not take into account that the housing market varies greatly from area to area across the US. In fact, there are many metro areas that are already either fairly valued or even undervalued compared to the forecast level.

Table 2 lists those metro areas that are undervalued and fairly valued, as well as the most overvalued across the country. Some of those areas, such as Detroit and to a lesser extent Cleveland are extremely undervalued due to external forces such as the general decline of those cities. However, the same certainly cannot be said for cities such as Denver, Atlanta, Dallas, and Charlotte. What does stand out when looking at this list is that the most overvalued areas are coastal cities, while the fairly valued areas are mainly southern and/or western interior cities.

So, are home prices really overvalued? The answer to the question is that it truly depends on the specific geographic region that is involved. On a nationwide basis, home prices are overvalued by nearly 31%. However, most of that is limited to

**Table 1: Forecast C/S-20 Home Price Index**

<u>Year</u>	<u>Beginning Value</u>	<u>Forecast Increase</u>	<u>Ending Value</u>
2000	100.00	3.79	103.79
2001	103.79	2.02	105.81
2002	105.81	2.94	108.76
2003	108.76	2.48	111.24
2004	111.24	4.07	115.31
2005	115.31	4.40	119.71
2006	119.71	3.52	123.23
2007	123.23	5.52	128.75
Apr-08	128.75	1.13	129.88

**Forecast Long Run Index Level: 129.88 (+3.19% per year)**  
**Current C/S-20 Index Level: 169.85 (30.77% overvalued)**

actual level for the price index was 169.85, or a gain of 6.56% per year. This means that on a nationwide basis, home prices have overshoot the average by a total of almost 31%.

One way to look at this is that it will take 8½ years of no increase in values in order for the index to be brought back in line with the forecast fair value. Of course, it will take less than that amount of time if housing prices continue to decline and more if prices should increase. The news is not all

less than half of the 20 metro areas that are represented in the S&P/C-S Home Price Index. It comes as no surprise to see that Miami, LA, Washington DC, and New York lead the charts in being extremely overpriced. It should also come as no surprise that those are the areas that are falling the fastest. For example, while the 20 city composite index fell by 15%, the Miami area fell by 26.7%, and Los Angeles dropped by 23.1%. In contrast,

**Table 2: Under or Fairly Valued Metro Areas**

<u>Area</u>	<u>Index</u>	<u>% Diff.</u>
Detroit	93.79	-27.8%
Cleveland	109.55	-15.7%
Dallas	120.41	-7.3%
Atlanta	124.19	-4.4%
Denver	128.49	-1.1%
Charlotte	131.82	1.5%

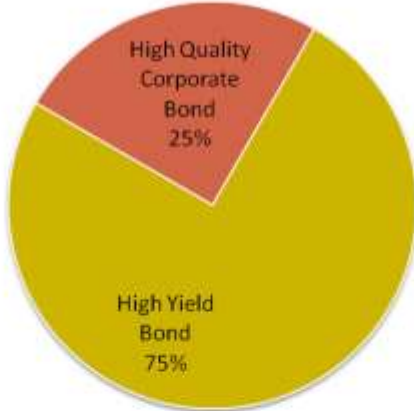
**Most Overvalued Metro Areas**

<u>Area</u>	<u>Index</u>	<u>% Diff.</u>
Miami	200.42	54.3%
Los Angeles	202.52	55.9%
Washington	201.21	54.9%
New York	193.93	49.3%
San Diego	180.57	39.0%
Seattle	179.57	38.3%

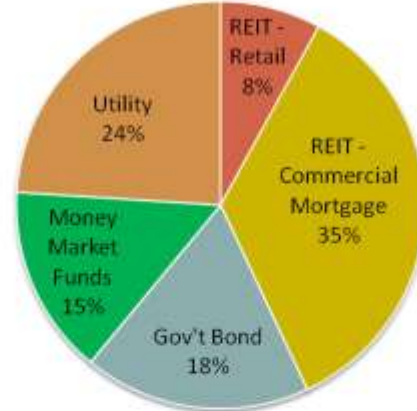
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# Current Investment Management Strategy Allocations

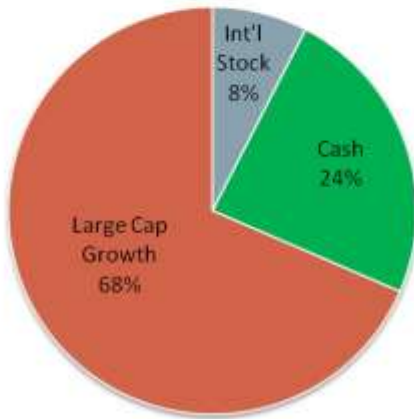
## Bond Strategy



## Current Income Strategy



## Stock Strategy



## Strategic Allocation Strategy



*(Special Focus, Continued from page 5)*

Atlanta fell by only 7.5%, Dallas fell by only 3.4%, and Charlotte was virtually unchanged.

So what should we take away from this study? First, while home prices nationwide remain heavily overvalued on average, that measure is greatly influenced by those areas that saw the greatest increases in their housing prices. In other words, the overvalued areas are concentrated in several specific metro regions. Second, there are many areas that have already returned to fairly valued levels. While the length of time that it takes to sell a home in these areas has extended considerably, those markets appear to be well on their way back to normalized conditions. Also, remember that it would

be very unusual for prices to overshoot and then simply return to their long-run average levels. It is more likely that prices, particularly in the most overvalued areas, will actually pull back below the long-run average before returning to normal levels. However, those that were not so overvalued will not be nearly as prone to an overcorrection on the downside. And finally, remember that in spite of what we experienced over the past few years, the real-estate market moves much more slowly than the stock market. It will very likely take a full decade for prices to settle back out to their normal levels. Some will return more quickly (and indeed may already have), and some may even take longer.