

# The Advantage Advisor

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## Market Commentary:

It has been said that the financial markets are driven by two things - fear and greed. Sometimes by both at the same time, which is exactly what appears to be the case these days. On the fear side of the equation, we see continued concerns over the credit crisis, resulting in values for many stocks and bonds that are far below their fundamental fair values. On the greed side, we see energy and commodities prices rising ever higher, even in the face of a lack of fundamental factors to support those prices.

Normally, an increase in supplies for a good will result in a drop in its price. Historically, this has been in the case when it comes to the price of crude oil. However, over the past several years this supply/demand relationship has broken down in the oil markets.

To see this, take a look at the chart below. The blue line shows the average number of days of crude oil that we had in inventory in the US. The red line shows the price of oil, adjusted for inflation to reflect today's dollar values. As you look closely at the chart, you can see that an inverse relationship emerges between price and inventory. That is, as inventories fall due to increasing demand, prices begin to rise. Similarly, as inventories begin to rise due to slowing demand, prices begin to fall. This relationship held true up until around the fall of 2003. At that point, inventories hit a bottom and began to rise, which should have led to a decline

### Market Statistics for May

Market Index	Closing Price	% Change
Dow Jones Industrial Average	12,638	-1.4%
S&P-500 Stock Index	1,400	1.1%
Russell 2000 Stock Index	748	4.5%
Shearson Treasury Bond Index	15,180	-2.2%
Dow Jones World Stock Index	291	1.4%
Nasdaq Composite Index	2,523	4.6%

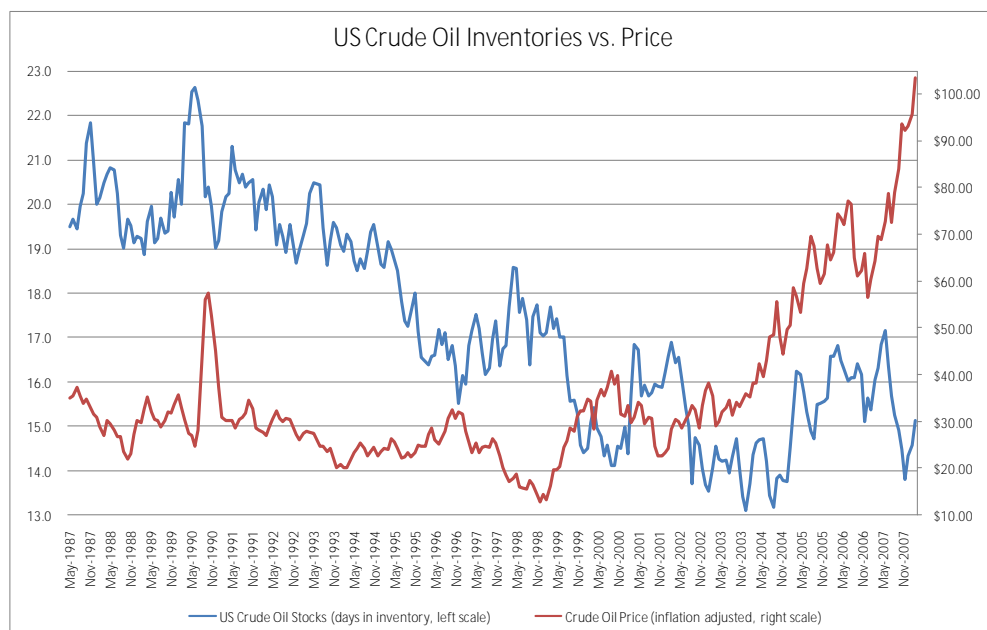
in prices. Instead, prices rose at an even faster rate and have continued to do so ever since, even in spite of increasing inventory levels.

What this demonstrates is that there are indeed factors outside of supply and demand forces which are affecting the price of oil in the US. Clearly global demand for oil is greater than at any time in the past, but so long as domestic inventories were rising, signifying a net decrease in demand, then prices should have fallen or at least remained at a stable level as a result.

Unfortunately, while this study helps to show there are outside influences, it does not tell us what they are, or what the natural price level for oil should be. However, all indications seem to be pointing to a severe speculative bubble forming in the market for oil. As a comparison, the run up in the NASDAQ composite index to the top of the internet stock bubble was 640%. The run for oil since it's last major decline back in 2001 has now surpassed 697%!

It would be unfair to try and say this is a purely apples to apples comparison, but it does help to illustrate just where this market has gone, and where it could head once the bubble bursts.

If the high prices are, as many suspect, being caused by the speculation of hedge funds, then the downfall of the oil markets could be quite similar to that of the housing bubble. Hedge funds borrow money to invest in the marketplace, but if that easy money suddenly comes to an end prices may fall breathtakingly fast. Then we will see the fear side of the market rear it's ugly head once again.



Source for Data: US Energy Information Administration, BP Statistical Review of World Energy, 2008.

# The Economic Picture

Any analysis of the economy of late comes down to a tug of war between two overriding issues: inflation and growth. The question is, has the Fed done enough to sustain our economic growth without leading us into a hyper-inflationary environment?

On the inflation front, we can see evidence that leads to concern. Energy prices, and to a slightly lesser extent food prices, are rising almost daily. These rising costs act as a tax on economic growth, effectively negating the stimulus that the Fed is trying to provide. However, the rate of core inflation, which strips away food and energy prices, remains very stable. Until we begin to see those pressures pass through to the core, the Fed is unlikely to make any significant changes.

On the growth front, the news is also both encouraging and concerning. Real GDP growth for the first quarter of 2008 was revised higher and may even top 1% when the final revision comes out at the end of this month. Productivity growth was also revised higher and remains strong. On the negative side, consumer confidence just hit a 16 year low. At the same time, the unemployment rate made a massive jump from 5.0% to 5.5%. Moves of that magnitude are extremely rare, and it is likely that this will be revised lower in subsequent reports.

In order to deal with this difficult combination, the Fed seems to be taking an approach similar to that of Alan Greenspan in the past. That is, to talk the marketplace into going where they want it to go rather than actually changing

Current Economic Position:  
Stage 5 - Contraction

## Economic Indicators

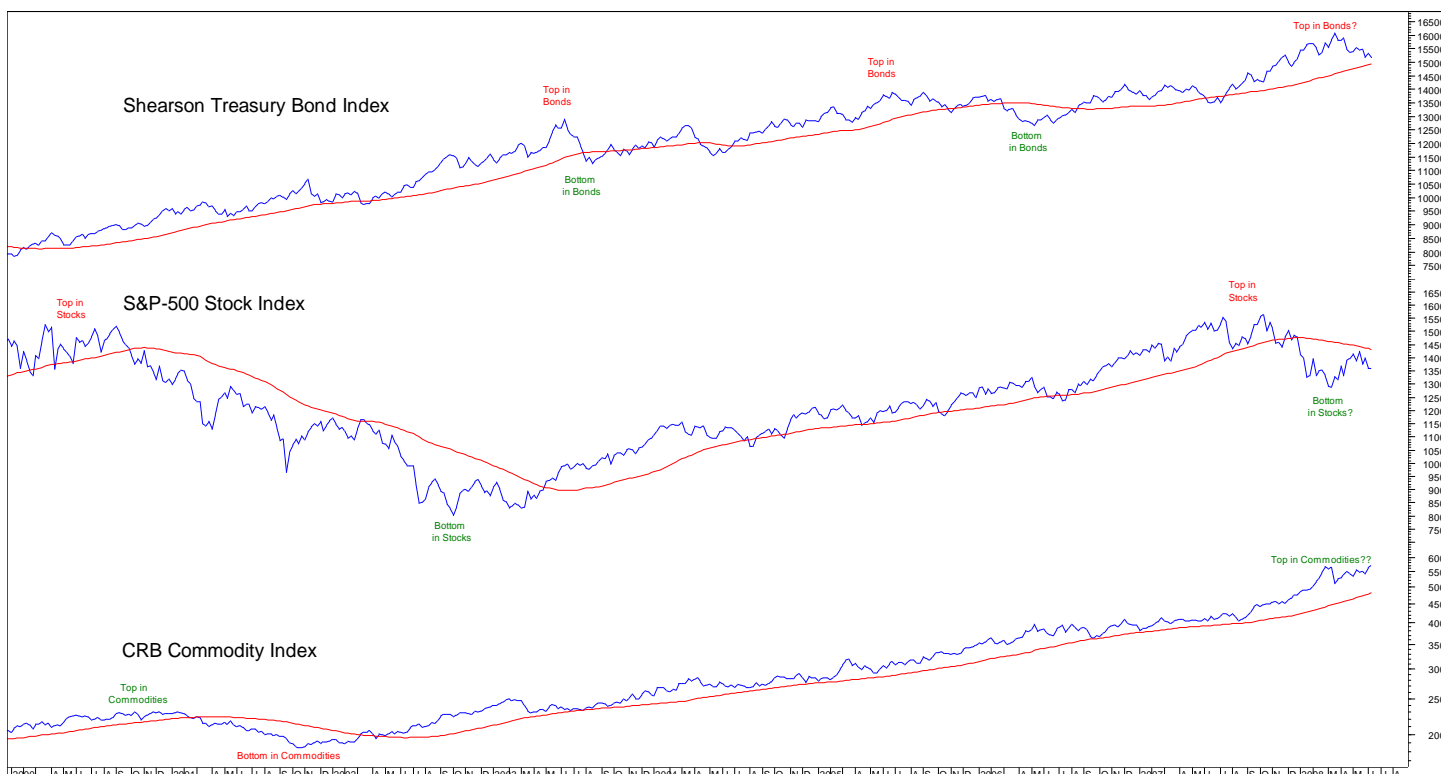
	Latest	Prior
<b>Growth</b>		
GDP	+0.9%↑	+0.6%
Productivity	+2.6%↑	+1.8%
Employment Cost Index	+0.7%	+0.8%
Capacity Utilization	79.7%	80.4%
<b>Inflation</b>		
Consumer Price Index	+0.6%	+0.2%
Core PCE Deflator	+0.1%	+0.2%
Implicit Price Deflator (GDP)	+2.6%	+2.4%
<b>Sentiment</b>		
Consumer Confidence Index	57.2	62.8↑
Unemployment Rate	+5.5%	+5.0%
Personal Income	+0.2%	+0.4%↑

↑=revised up, ↓=revised down

Source: Moody's Economy.com

policy. In fact, even Mr. Greenspan himself has made remarks to that effect as he noted that there is now a "reduced possibility" of a pronounced recession and that the financial markets have shown a "pronounced turnaround" since March.

There is no doubt that eventually the Fed will begin to raise interest rates again, probably beginning with the new year. That possibility has put much needed support under the value of the US Dollar. Weakness still remains for us in the housing sector, but that will likely take several years to fully recover. In the mean time, if I had to forecast a winner in the tug of war, it would be for growth to come out ahead of inflation - and that would be a win for all of us.



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.*

So far in this series, we have looked at the first four problematic financial behaviors. These are ways that investors behave at different times that can negatively impact their investments. This month we'll take a look at three related behaviors: Reference Point, Representativeness and Familiarity.

Problem: Reference Point

Most of us are familiar with the concept of a reference point, but in the positive sense. To illustrate, imagine you are in a rowboat and need to cross a lake. When you are rowing, you are normally facing the opposite direction from the way you are traveling, so it can be very hard to navigate. In order to keep yourself in line, you can pick a reference point on the shore that you are leaving. So long as you keep this point in the correct perspective, then you can be assured of traveling in a straight line and getting across the lake with as little difficulty as possible.

In investing, a reference point works in much the same way, but can do more to lead us astray than to the right destination. In investing, a reference point generally occurs at a high or low point in value or on a specific date. For instance, we often reference the value of an account as of the first of the year, and then speak about return from that point forward.

The problem with this occurs when we create reference points not out of particular dates, but out of highs and low price points. For example, imagine you purchased a stock in January of 2005 at \$25. This stock appreciated considerably and closed out the year at a price of \$50. In 2006 however, the stock fell upon harder times and dropped back to \$45. Depending upon the investor's reference point this could be viewed as either an 80% gain (\$25 rising to \$45) or a 10% loss (\$50 falling to \$45). It may seem like a small issue, but having the wrong reference point could easily put the investor off-balance and cause bad trades to take place.

For instance, the 10% loss perspective could cause the investor to become unduly risk averse and

## 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

lead him to become too conservative in his choices. It could also keep him from selling the investment now, choosing instead to wait for the price to climb back up once again, which it may not do. This ties in very closely to last month's topic on fear of regret and seeking pride.

Using a high or even a low price as a reference point to guide trading decisions has other ramifications as well. If an investor wants to own a stock that has just moved above its 52 week high, he may go ahead and buy the stock at that

high price for fear missing the boat while it zooms even higher. The same can be said for selling a stock near its low price. Either way, the focus is taken off of the fundamentals of whether or not it is a good investment, and shifted to where prices are relative to the reference point.

Problem: Representativeness and Familiarity

Representativeness and Familiarity both work in a similar fashion. In each case, they cause investors to jump to a conclusion before all of the information

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and facts have been reviewed. Most times, representativeness occurs simply because of the vast amounts of information that are available to be reviewed. The brain simply cannot process all of the available data, so it takes short cuts based on past experiences or biases. A classic example of this is the following riddle:

*A highly skilled chief surgeon is summoned to the operating room to help with an emergency. A patient was in a car accident and needs immediate surgery to save his life. The doctor rushes into the operating room and suddenly stops short, exclaiming, "I cannot operate on this person, he is my son". However, the surgeon is not the boy's father - how can this be the case?*

Those who are familiar with this riddle already know **that the doctor is really the boy's mother.** For most people though, a man better represents the position of a highly skilled chief surgeon. Thus, representativeness has caused our minds to jump to a conclusion without knowing all of the facts.

Familiarity is closely related to representativeness. With familiarity we allow our current knowledge of a thing or situation to influence our decisions about it. In investing, there can exist a vast difference between a good company, or one with which we are familiar, and a good investment.

Just because a company has a great product or service, and one that you know and enjoy, does not make it a great investment. The quality of the company is only one part of the puzzle. The price of the investment is the other part. There are many great companies that we can buy, but the price of those shares may or may not be justified by the fundamentals of the company itself. However, familiarity with that company can lead us into thinking that it is always a great investment, and we can make a buy or sell decision at the wrong time without all of the necessary information.

The most obvious case of both representativeness and familiarity is during a market bubble. During the dot-com boom of the late 1990's, stocks were being bought solely on the basis of familiarity with their future product and representativeness of other high tech companies that had made great money for their investors. In many cases, these companies had not even produced a product let alone generated a profit. In order to support their buy recommendations, analysts began to rate these dot-com companies on the basis of sales revenues rather than actual profits. For fear of missing out on great gains, investors made the jump into buying these stocks without having considered all of the truly relevant information.

Another example of this phenomenon is in mutual fund investing. Year after year, the funds with the best recent track record receive the highest amount of new investment inflows. However, studies have shown that subsequently these high flyers tend to under perform the losers, those with the worst recent track record, over the next 3 years by as much as 30%.

Clearly, the problem with all three of these behaviors: Reference point, representativeness, and familiarity, is that they cause us to make decisions without reviewing all of the pertinent information. Taking these short cuts can lead us to make decisions which in the end can be downright disastrous.

Warren Buffet, the well known investment guru, once compared investing to being up to bat in a baseball game. Only in his version of the game there were no strikes, only balls and hits. He asserted that the key was in having the patience to wait for exactly the right pitch, and not to swing at one because you just wanted to hit something. You always need to make sure you hit the pitch that will go the farthest, even if it means missing a few that are 'pretty good' in the process. **The market will always throw you another good one if you just have the patience and focus to keep looking for it.**