

# The Advantage Advisor

Volume 12, Issue 5

May, 2008

## Market Commentary:

The chart at the bottom of the page illustrates just how far we have come over the past two months. It is a chart of the cost to insure corporate debt against the risk of default, also known as a Credit Default Swap. This index began a tremendous upward run (meaning increasing risk) at the beginning of March. This culminated in a peak which took place right at the same time as the bailout of Bear Stearns by both the Fed and JP Morgan Chase. Within 45 days after that event, risk levels had fallen by 50%, and though they are slightly higher today, the downtrend is still firmly intact.

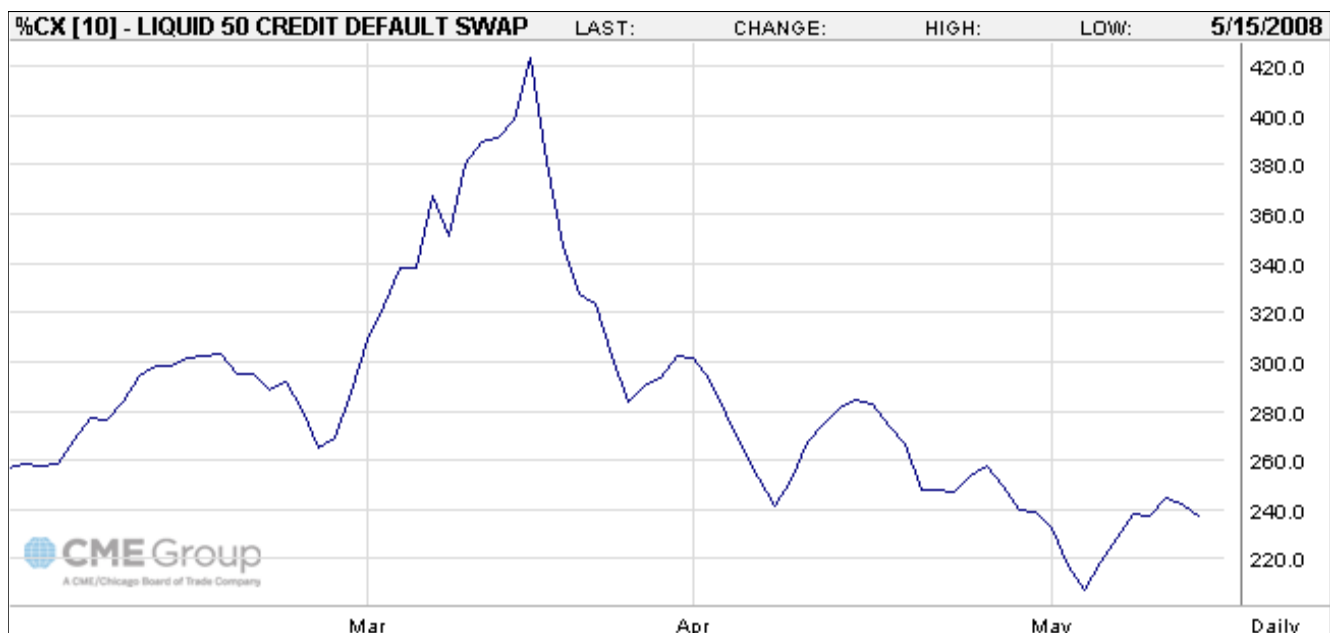
The result of this easing of risk in the marketplace is the continuing rally that we have seen in both the stock and corporate bond markets. It has also resulted in a pullback in the US Treasury Bond market, which posted the sole losing performance in the table of indices to the right. Clearly, capital is beginning to flow out of safe haven assets and back into the marketplace.

Summer can be a tough time for the financial markets, with many traders and investors going on vacation. However, given our recent bear market this has the potential to be a much more productive summer

Market Index	Closing Price	% Change
Dow Jones Industrial Average	12,820	4.5%
S&P-500 Stock Index	1,386	4.8%
Russell 2000 Stock Index	716	4.1%
Shearson Treasury Bond Index	15,517	-2.0%
Dow Jones World Stock Index	287	5.0%
Nasdaq Composite Index	2,413	5.9%

than most. Continuing improvement in the economic picture as well as strong, steady performance in the financial markets have led us out of defensive postures and back into a fully invested position across all of our investment strategies. We don't expect the markets to suddenly shoot back up to new highs from here, but we do anticipate that they will end the year substantially higher than they are at present.

Certainly there are risks that remain. Commodities prices remain very high, the credit crisis is still not quite finished, and the housing market is getting set for another wave of foreclosures. But the financial markets are a forward looking mechanism, and it appears that these risks have already been factored into prices in some manner. Therefore, our forecast is shifting from defensive to cautious but optimistic as we look for solid gains by the end of the year.



# The Economic Picture

Looking at our Index chart below, it appears as though the Fed may well have engineered a soft landing, allowing the US economy to avoid an all-out recession. It would also mean our economic cycle analysis could see a roll back into Stage 3 - Growth. That is not unheard of, but it is unusual. The last time something like this took place was back in the mid 90's with the Fed under the leadership of Alan Greenspan.

We saw some very friendly economic reports released over the past several weeks. One of the best was the CPI report, which came in lower than expected and eased concerns over rising inflationary pressures. The three month annualized change in CPI came in at 2.3%, just one-third the level where it stood back in January. It is also 40% less than the increase shown over the past twelve months, indicating that it is continuing to decelerate.

The implication of stable inflation for interest rates is that the Fed has room to maintain lower rates for a longer period. As soon as it appears inflation will become an issue for the broad economy, they will most certainly begin to increase rates once again. At present, the markets are forecasting interest rates to remain unchanged for the balance of 2008, and then to slowly increase beginning in early 2009. The idea that the Fed may finally be done cutting rates has also put a firm floor under the value of the dollar, which has improved steadily over the past several weeks.

So for inflation, the big question that remains now

Current Economic Position:  
Stage 5 - Contraction

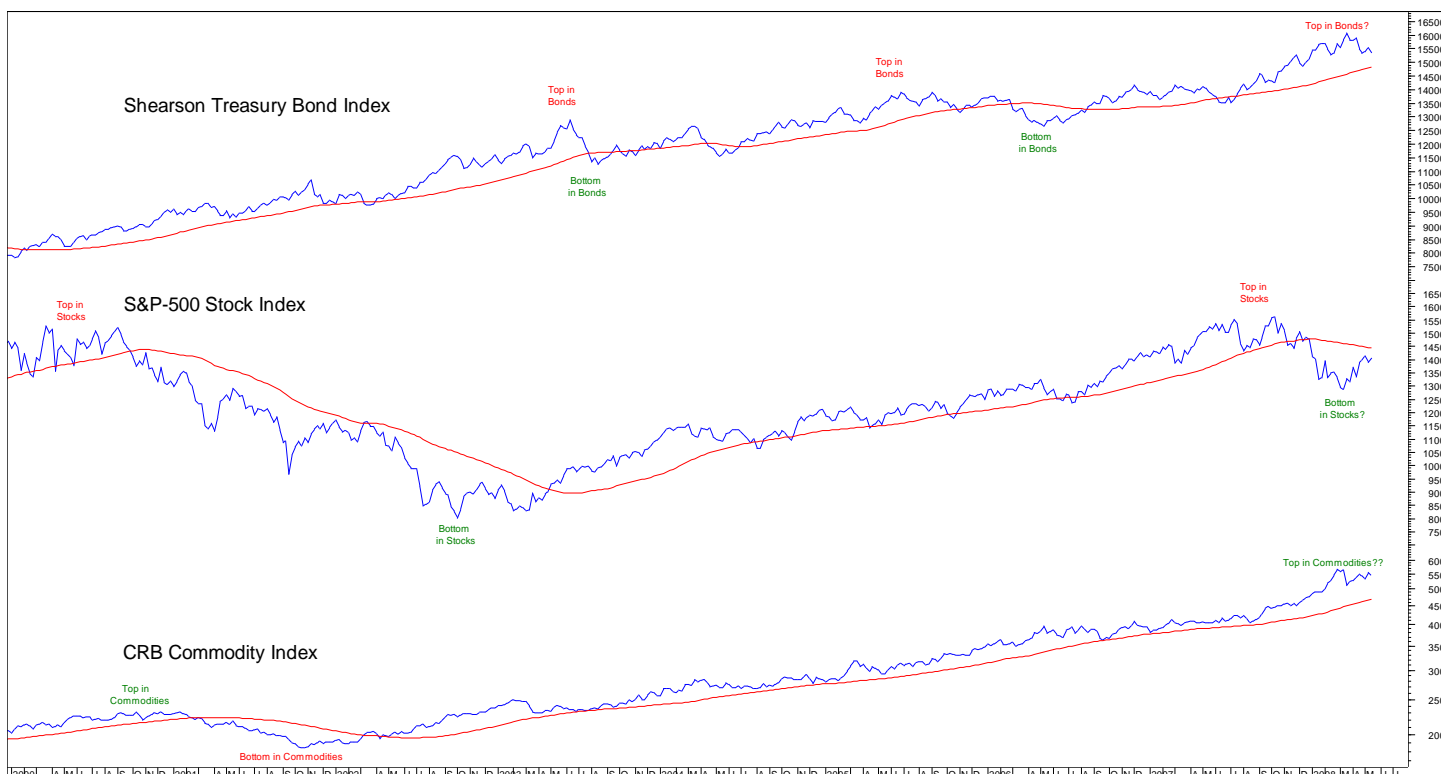
## Economic Indicators

	Latest	Prior
<b>Growth</b>		
<b>GDP</b>	<b>+0.6%</b>	<b>+0.6%</b>
<b>Productivity</b>	<b>+2.2%</b>	<b>+1.8%↓</b>
<b>Employment Cost Index</b>	<b>+0.7%</b>	<b>+0.8%</b>
<b>Capacity Utilization</b>	<b>79.7%</b>	<b>80.4%↓</b>
<b>Inflation</b>		
<b>Consumer Price Index</b>	<b>+0.2%</b>	<b>+0.3%</b>
<b>Core PCE Deflator</b>	<b>+0.2%</b>	<b>+0.1%</b>
<b>Implicit Price Deflator (GDP)</b>	<b>+2.6%</b>	<b>+2.4%</b>
<b>Sentiment</b>		
<b>Consumer Confidence Index</b>	<b>62.3</b>	<b>64.5</b>
<b>Unemployment Rate</b>	<b>+5.0%</b>	<b>+5.1%</b>
<b>Personal Income</b>	<b>+0.3%</b>	<b>+0.5%</b>

↑=revised up, ↓=revised down

Source: Moody's Economy.com

appears to be: When will the commodities price bubble burst? In a recent interview, billionaire investor Wilbur Ross speculated that a decline in the price of oil in excess of \$15 per barrel would set off a round of margin calls for the hedge funds that are speculating so heavily in that market. The effect of this would be very similar to what happened with the sub-prime meltdown last year as those fund managers are forced to sell off assets in order to meet the call requirements. That could drive commodities prices down substantially. Unfortunately, there is no way to predict the nature of such an event. But if it does occur with sufficient magnitude, we could even face the prospect of a deflationary scenario unfolding.



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.*

Last month, we took a look at the problems of Overconfidence and The Illusion of Knowledge. This month we'll look at the next two behaviors: Fear of Regret and Seeking Pride, and Mental Accounting.

Problem: Fear of Regret and Seeking Pride

This problematic behavior is actually very easy to understand but very difficult to overcome. It is human nature to avoid situations that cause us pain or regret. On the other hand, it is also human nature to seek out situations that make us feel better about ourselves.

When it comes to investing, we do exactly the same things. When we purchase a stock, we do so with an expectation that it will rise in value, giving us a positive return. However, that does not always happen. Some stocks rise, others fall, some even collapse. When those investments fall and the owner is faced with a loss, most have a tendency to hang on to the stock in the hope of a turnaround. Many investors have been caught in this trap and held those losing stocks until they were simply worthless pieces of paper.

Just the opposite can be true when it comes to those stocks that are big winners. An investor that has a big winner, especially if it moves up very quickly, will

have a tendency to sell the stock at the first sign of trouble in order to lock in the gains and show just how great an investment they made.

One of the problems with this kind of thinking is the impact of taxes upon a portfolio. If you sell a stock that has gained in value, you will pay taxes on that gain (retirement accounts excluded). That tax effectively reduces the amount of the gain. Conversely, if you sell a losing stock, you get a tax credit for the loss, and that tax credit actually reduces the amount of the loss. From a purely economic standpoint then, the old Wall Street axiom makes perfect sense: "Sell your losers and let your winners ride." Unfortunately, in wanting to avoid the pain and regret of realizing a loss, many investors do exactly the opposite. This is known

as the disposition effect, where investors appear to be predisposed toward selling their winners too early and holding their losers far too long.

Here is an example to help flesh this out a bit: Say an investor owns two stocks, A and B. Stock A was purchased for \$850 and stock B for \$1,250. Also assume that the capital gains tax rate is 20%. Time passes and the investor finds himself in need of \$1,000 which he will take from this portfolio. He looks to see which stock to sell and finds that each of the two stocks is now worth ex-

actly \$1,000. Which one should he sell?

Selling stock A will yield a gain of \$250, while selling stock B will yield a loss of \$250. In both cases the investor would raise the \$1,000 he needs. The disposition effect would predict that the investor would sell stock A instead of stock B so that he could avoid realizing the regret of the loss and capture the good feeling of having made a winning investment choice.

However, if taxes are factored into the picture, we see that stock A was definitely not the best economic choice. Selling stock A gives the investor a gain

## 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

*(Continued from page 3)*

of \$250, which triggers capital gains taxes of \$50 for net after-tax proceeds of only \$950. Selling stock B causes the investor to realize a loss of \$250, but that capital loss provides him with a tax deduction that is worth \$50. This equals net after-tax proceeds of \$1,050, which is a much better choice.

The caveat here is that there may be other reasons to hold onto a losing position. One such reason might be if we know that the loss is indeed a temporary issue. Each investment must be viewed within the bounds of the long-term trend, and the riskiness or volatility inherent within that stock. In the end **though, the axiom certainly does seem to be true: “Sell your losers and let your winners ride.”**

Problem: Mental Accounting

While it may sound like some kind of memory game for CPA's, **mental accounting really has little to do with actual accounting.** In fact, mental accounting is more closely related to the fear of regret and seeking pride. In mental accounting, the investor tends to place each investment into a separate, imaginary account. This is usually based upon the intended uses of the invested capital, the type of specific securities involved, or even the current status of the investment. For instance, an investor might set up one account for retirement savings, another for vacation savings, and another as a Christmas fund. The problem with this thinking is that it causes the investor to overlook the interactions between their investments.

In **“The Psychology of Investing”**, John Nofsinger again offers a good example of the outcome of this thinking:

*Consider the wealth-maximizing strategy of a tax swap. A tax swap is when an investor sells a stock with losses and purchases a similar stock. For example, suppose you own Northwest Airlines stock, which has experienced a price decline along with the entire airline industry. You could sell the*

*Northwest stock and purchase United Airlines stock. This tax swap allows you to capture the capital loss of Northwest stock to reduce your taxes while staying invested and waiting for the airline industry to rebound.*

***Why isn't the tax swap strategy used more often?*** *Investors tend to consider the selling of the loser stock as a closing of that mental account and the buying of the similar stock as the opening of a new mental account. This causes two outcomes that affect investors. First, the interaction between these two accounts increases the investor's wealth. Second, the closing of the loser account causes regret. Investors tend to avoid the interaction between accounts; therefore, investors act to avoid regret instead of to maximize wealth.*

This is just one example of this behavior, but it does demonstrate just how we need to be aware of the big picture as we view our financial holdings. This means seeing each account as a piece of the entire portfolio. Each piece plays its own role in meeting the goals of the portfolio as a whole - that is maximizing wealth while reducing risk. By focusing only on individual mental accounts, we lose track of that big picture and begin to make choices that we would not otherwise.

Fear of Regret, Seeking Pride and Mental Accounting are behaviors that occur when we lose sight of the big picture and allow emotions to cloud our judgment. Disciplined investing means that we set forth a course of action and follow those rules in spite of emotional distractions.