

Lowly Analyst Newsletter

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Insurance

Insurance firms have a reporting system by ChoicePoint called C.L.U.E. (www.choicetrust.com). This system reports claims and inquiries about your record for auto and property insurance, and even records conversations with agents about damage. You can get one free report per year.

For a fee, C.L.U.E. also provides credentials of healthcare professionals, nursing homes credentials, household workers (nannies, caregivers, housecleaners), contractors, and more. It further provides home sellers' disclosures, employment history, and tenant history reports.

ChoicePoint also provides a home insurance score computed from credit reports. This report scores insurance risk.

The Economy and the Markets

The outlook for the US stock market is still good in spite of it being overvalued. Foreign central banks are continuing to diversify out of Treasury Bonds and into bonds of foreign treasuries, as well as into domestic and foreign assets.

Asset Classes: For the past 6 months: Mid value up 10%, Mid growth 10%, Large value 10%, Large growth 8%, Small growth 8%, Small value 5%

Sectors: For the past 6 months: Telecom up 20%, Energy 18%, Natural Resources 18%, Materials 17%, Metals 16%, Utilities 14%, Oil 12%, Industrial 11%, Health Care 10%, Commodities 10%, Consumer Goods 7%, Consumer Services 6%, Gold 5%, Tech. 3%, Real Estate down 7%.

Foreign Investing: For the past 6 months France up 65%, Venezuela 49%, Brazil 39%, Malaysia 36%, Turkey 36%, Indonesia 29%, Latin America 27%, Mexico 27%, Singapore 27%, Poland 26%, Israel 24%, Germany 24%, S. Africa 24%, Denmark 23%, Australia 23%, Austria 22%, Sweden 22%, Columbia 21%, Chile 20%, Hungary 20%, Czech Rep. 20%, Pacific Rim 20%, Pakistan 18%, China 18%, Emerging Mkts. 17%, India 16%, Europe 15%, Developed World 14%, World 8%, Russia 4%.

Market Irrationality I

1. Traditional Economists's View.

Traditional economists hold that markets are efficient and properly priced most of the time. This pricing has two principle requirements: a). There are always arbitrageurs, and b) that arbitrage has no risk and only a small cost. Unfortunately, neither holds true. This issue, coupled with investor biases and behavior, are some of the factors which we will discuss that cause inconsistencies and errors in market prices.

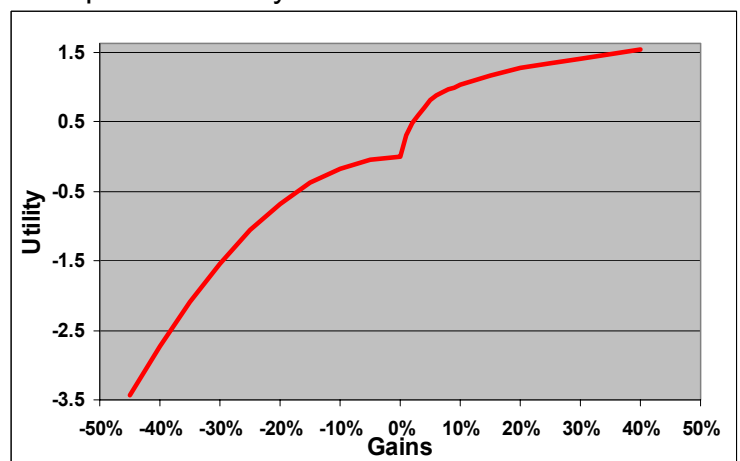
The study of investor behavior is called behavioral economics. (See R. H. Thaler, *Recent Advances in Behavioral Economics*; M. M. Pompian, *Behavioral Finance and Wealth Management*). Investor behavior was studied by analyzing a large number of individual brokerage accounts.

2. Utility Theory.

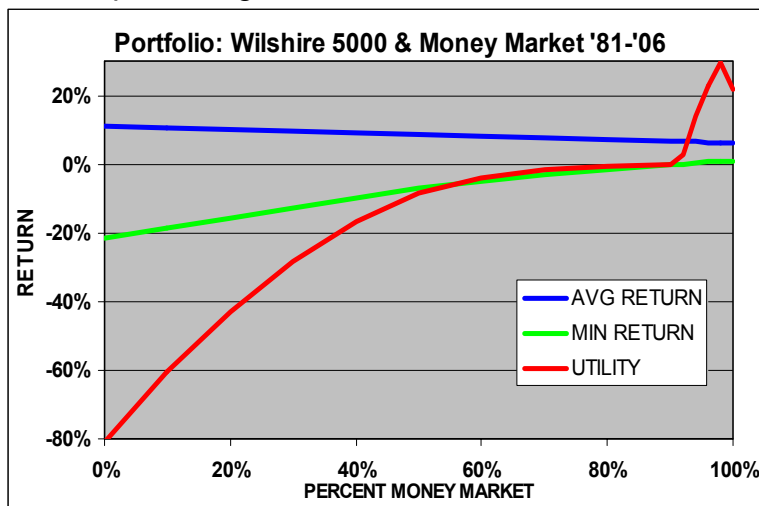
Utility is the relative amount of pleasure derived from gains or the relative amount of displeasure from losses. Notice, it is the gains and losses not the absolute amount of wealth that is a function of utility, and this function differs for each individual.

The incremental amount of utility decreases with increasing gains. Also, a sizable loss gives us more displeasure than the pleasure we would receive from a comparable gain. That is that we feel our losses more than our gains. So, unlike gains, the incremental amount of displeasure increases with increasing losses. The shape of the utility function together with limits to arbitrage can explain many market abnormalities.

The figure below shows a possible utility curve. Each person's utility curve will look different.



Now, let us look at results from investing in the US stock market and in money market funds at various percentages.



The above graph shows the average returns, minimum returns (largest one-year losses), and the utility achieved at various portfolio weighting between the Wilshire 5000 index and a money market fund. Note that a portfolio of 100% Money Market never had any losses and hence the largest utility (but the lowest return). Also, holding more than 50% in Money Market did not substantially increase the utility. With more than 50% in stocks, the maximum draw-downs were more than 10%. These large draw-downs will again occur in the future.

3. Overconfidence

Investors typically believe that they are far better investors than they actually are. They remember their successes, forget their losses, and inflate the value of internet information which provides little or no actual improvement. A good example of investor overconfidence is the fact that increased trading often occurs in spite of decreasing returns. The trader thinks he has information when in fact he does not, and the additional confidence gained from internet access results in more frequent trading, and greater losses.

4. Hold on To Winners, Sell Losers

Investors sell winners too early and losers too late. They do not maximize gains, particular in taxable accounts. We have a loss if we realize it or not. This is because investors dislike losing more than they like gaining, and the fear of losing is the motivator to sell a winner too quickly.

5. Insufficient Diversification

Investors do not adequately diversify their portfolios. There is also a “home market bias” that

causes the investor to hold more US stocks and bonds than is justified. In particular, investors hold too few emerging market securities. Home market bias is particularly bad because of the high correlation with human capital (your earnings potential).

Additionally, home bias is prevalent because investors dislike, and even fear, the ambiguity of unfamiliar asset classes.

6. Small Cap Bargains

Small cap stocks in the smallest decile (microcap) historically had on the average 9% per year higher returns than the highest decile. This discrepancy cannot be explained by higher risk. It is important to note that not all small cap funds hold only small cap stocks, though DFA microcap and small cap funds do.

7. Value Stock Bargains

Stocks are often classified as value or growth stocks. Value is usually defined as high book value relative to market capitalization (B/M), where market capitalization is share price multiplied by the number of shares outstanding. Value stocks in the lowest decile had 18% higher returns (on average) than growth stocks in the highest decile. This difference cannot be explained by differences in risks. Note that not all funds called “value funds” hold only value stocks. Again, DFA funds do.

Another useful measure of value is the price-earnings ratio (PE). The lowest price earnings ratio decile had 8% higher returns than the highest decile.

8. Co-Movements

Stocks that trade in the same market influence each other. That is one reason why it is better to hold foreign stocks than multinationals.

9. Summary

We have shown that the assumptions of traditional economists have recently been challenged. The price is not always right. We dislike losses much more than we enjoy comparable gains. Holding more than 40% of your portfolio in fixed income does not significantly increase your enjoyment because of the shape of the utility curve but it does decrease your returns. We must guard against not selling losers. Finally, it is essential to guard against overconfidence, a lack of sufficient diversification, a lack of investment in small cap, and an overinvestment in growth stocks.

In a future letter we will discuss other investor biases.