Lowly Analyst Newsletter

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Credit Cards. Blue Cash from American Express 5% supermarkets, gas station, drugstores after 6,500/yr; 1.5% everything else.

Discover Open Road Card 5% gas, max $60/yr.; 1% all else.

Inflation. The cost of living inflation is different for everyone. For most of us it is higher than what the Government says. As I showed in a previous letter, the cost of living inflation increases with age because of healthcare and the increasing necessity to buy services rather than perform the tasks yourself.

Food and energy are an important part of expenses and cannot be ignored. Inflation is probably at least 4% and higher for seniors. You can easily measure your particular increase in cost of living by tracking your expenses.

The Economy and the Markets

The near term outlook for the US stock market is still good because of the devaluation of the US dollar. Foreign central banks continue to diversify out of Treasury Bonds into bonds of foreign sovereigns and invest in domestic and foreign assets.

Asset Classes: For the 6 months small growth up 9%, mid growth 9%, large growth 8%, mid value 8 %, large value 6%,. micro 4%, small value 3%.

& Mining 28%, Int.l Basic Matrl.28%, Oil Equip. 27%, Oil Service 26%, Intl. Industrl. 22%, US Aerospace 18%, Glbl. Telec.14%, Water Rsrcs 14%, Intl. Utilities 10%, High Tech. 10%, Semicondctr 8%, Med. Devcs, 8%, Cons Staples 8%, Commodities 5%, Gold -5%.

Foreign Investing: For the past 6 month Brazil up 31%, Malaysia 30%, Latin America 26%, Germany 23%, So. Korea 22%, Sectors: For the 6 months, Steel up 41%, Metal Singapore 22%, Sweden 22%, Australia 21%, Mexico 21%, BRIC (Brazil, Russia, India, China) 20%, Pacific-Ex J. 18%, Canada 18%, China 16%, Netherlands 15%, Europe 12%, France 12%, Taiwan 10%, United Kingdom 9%, Austria 9%, S.Africa 9%, Spain, 8%, Belgium 8%, US 7%.

Market and Investor Irrationality II

1. Traditional Economist's View.

In June *Lowly Analyst* we discussed some market irrationality. We will continue to discuss some of the biases that influence investor behavior and show that the price is not always right.

Traditional economists hold that most of the time markets are efficient, hence properly priced. This requires that a. there are always arbitrageurs and b. that arbitrage has small risks and small costs. Unfortunately neither is the case.

The study of investor behavior and bias 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 investor brokerage accounts.

2. Conservatism

Most investors are too conservative. This tendency causes low volatility stocks and fixed income to have lower returns than they would otherwise have and the premium of equity over to bonds to be too low.

Perhaps the most important factor in conservatism is investors misunderstanding of risk. A previous newsletter was devoted to risk and showed the consequences of various amounts of risk on the time the investor runs out of money.

The true risk is not volatility but the probability that the retirees do not meet their objectives e.g. runs out of money.

Investors often think that the higher the risk, the lower the return instead of realizing that the higher the risk the higher the return.

An investor can withdraw the largest amount without running out of money if her risk is about the risk of the total US stock market.

In addition, investors tend to be overly optimistic on returns .The sustainable withdrawal rate is only about the same as the required minimum distribution, no more that is 3.6% at 72. If a money market fund at that withdrawal rate gives you enough cash flow, why take any risk? If a prudent

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withdrawal rate does not provide sufficient cash flow the investor must take more risk.

Another factor for conservatism is the utility curve, discussed last month, that losses cause us twice as much displeasure than the pleasure of gains and the fact that each percent of additional loss increases the amount of pain by a larger and larger amount while each additional dollar of gain increases pleasure by a smaller and smaller amount.

3. Domestic Bias

Most investors have a preference for domestic stocks and under-weigh foreign securities. Domestic assets are less than 50% of world invested assets. The percentage is decreasing. Multinationals are not as good a diversification as foreign stocks because of the co-movement effect discussed in the last letter. The market where security trades influences the security movement.

4. Anchoring

Investments have an outcome that is a probability distribution. When we have to estimate ranges we estimate too narrow a range. If we know today's earnings, we usually estimate future earnings much too close to that number than we should.

Once we establish a belief, we tend to hold on to that belief and ignore evidence to the contrary. For example after favorable earnings announcements prices do not immediately adjust. Over the next 60 days they had a 4% abnormal return. Part of the problem is that we remember our successes better than our failures.

5. Representativeness

What investors hear and what they remember is different. Investments are often made on a sample of past events, the sample should be representative. To get such a sample is extremely difficult.

Investors think that a fund will go up next year about the same percentage next year as it did the previous year, even when the total past history is available to them.

One of the problems is that investments are generally influenced by many factors. Because something is a value stock, makes it neither a good or a bad investment. Many other factors influence the future success of the firm, e.g., the particular industry the firm is in. When a dividend is increased investors tend to think wrongly that the growth rate in dividend payout has changed.

6. Index Inclusion

Many Stock indexes pre-announce changes to the index. S&P usually pre-announces by 2 weeks. This means that there is front-running and the index funds have to pay a premium for the stock. As is well known, stocks recently included in the S&P have a lower total return than the index. One should not buy a stock because it has recently been included in the S&P.

7. Carve-Outs (listed subsidiaries)

A good example of a carve-out is the pricing of Palm and 3Com. Investors could buy 15 shares of Palm directly or 10 shares of 3Com that gave them 15 shares of Palm plus some 3com. On one day Palm at 95.06 and 3Com closed at $104.13 instead of $142+. The miss-pricing went on for months, despite discussions in the Wall Street Journal and the New York Times.

8. Ignoring Events

Stocks with good (bad) earnings surprises tend to outperform (under perform) by 4% for sixty days in one study. Similarly, in another study stocks that initiated (omitted) dividends tend to over-perform, as did stocks that initiated (abandoned) stock repurchases.

9. Closed-end-funds

It is well known that closed end funds sell at discounts and premiums from their net asset value, while mutual funds sell at net asset value. Generally, closed end funds sell at a discount. In early June the discounts were as low as -21% and the premiums as high as 84%. Closed end funds can be leveraged.

10. House Money

Individuals often think erroneously that if they lose no more than their previous gains that that is not as bad as if they lose other moneys when it is exactly the same.

11. Summary

Markets are not always efficient. For markets to be efficient requires a) that there always is an arbitrageur and b) that arbitrage has little cost and risk. Neither is true. Investors tend to be too conservative, have a domestic bias, underweight foreign securities more then is required for good diversification, invest on the bases of non representative data, and hesitate to change their beliefs.