

Lowly Analyst Free Newsletter

Volume 9, Issue 11 November 2009

www.CurtFey.com

In this Issue

Power-of-Attorney

The Market

Investing in Volatile Markets

Power-of-Attorney

New York has issued a new [Power-of-Attorney form](#). Financial institutions must accept this new form. Currently many financial institutions accept only their own form. Both the old and the new form are valid.

The Market

The [dollar has been falling](#) as it is losing its status as the currency of last resort. With our proclivity for spending and increasing foreign borrowing, the outlook for the dollar is cloudy.

The [World Bank forecasts](#) a drop in World GDP of 1% for this year and continuation of world wide unemployment. The current uptrend is under pressure. After the recent advances we are in for a bumpy ride.

Currencies: October, Britain up 4%, Mexico 3%, Euro 1%, Switzerland 1%, China 0%, US\$ down 1%, Japan -2%.

Asset Classes: October, Large Growth down 1.3%, Large Value -3%, Midcap Growth -4%, Midcap Value -5%, RAFI US Large Cap -6%, Small Value -6%, Small Growth, -7%, Micro -9%, Small Cap Pure Value -17%.

Sectors: October, Global Carbon up 10%, Oil 9%, Commodities 7%, Gold 4%, Energy 2%, Agric Commodities 0%, RAFI Intrnl Real Est 0%, Oil Eqp & Srv 0%, Nat Rsrc 0%, Cnsmr Gds -1%, Coal -1%, Agri Busn -1%, Tech -1%, Silvr -2%, Gbl Telecom -2%, Cnsmr Srv -2%, Gbl Mtrls -2%, Hlthcr -3%, Mngd Futures -3%, Steel -4%, REIT -4%, Lumber -5%, Financials -5%, Solar Energy -15%

Foreign Investments: October, China 2%, Brazil 2%, Russia 1%, Latin Am 0%, United Kingdom 0%, Mexico 0%, EAFE Growth down 1%, Europe Total Div -2%, All World -3%, All World - Europe -3%, US -3%, Australia -3%, Pacific-J -3%, Emerging Mrkt -4%, Japan -4%, S Africa -5%, Canada -6%, India -7%, S Korea -10%

Fixed Income: October, High Yld up 1.3%, TIPS 1.1%, Intl Gvmt Infl Protected 0.8%, Mrtg Bckd 0.8%, Absolute Strategies 0.7%, GNMA 0.3%, Total Bnd Mrkt 0.3%, Intrm Gvmt Credit Bonds 0.3%, Shrt Term 0.1%, Intrmd Trm 0.1%, 3-7 Yr Tres 0.2%, 1-3 Yr Tres 0.1%, Intrntl Tres 0.1%, Tax Free Wkly 0%, Emrgng Mrkt Gvmt down 0.5%, Natnl Munis -2.6%, Preferreds -2.8%, Coverd Calls -4.5%

Investing in Volatile Markets

1. Introduction

This is a review of the book [Animal Spirits](#) by 2001 Nobel Prize winner [George Akerlof](#) and Yale professor [Robert Shiller](#). The book shows that contrary to [investing theory](#), markets are [not always efficient](#) and humans do not solely pursue their own best interest. Their [psychology drives markets](#) to a [significant extent](#). You can use the books insight to improve your own investment performance.

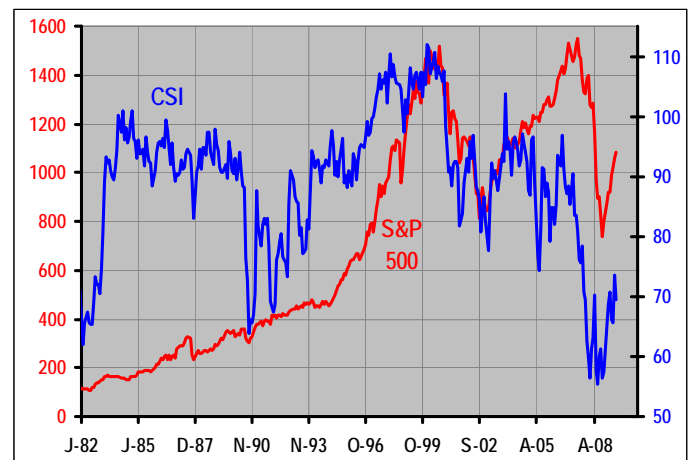
2. Five Factors that Influence Markets

[Akerlof](#) shows that humans have difficulty with handling uncertainty (volatility) for 5 principal reasons:

- Importance of Investor Confidence. Investor confidence affects the market and the feedback between confidence and the market amplifies volatility.
- Influence of the Money Illusion. Investors fail to account properly for the effects of inflation and the time value of money, the fact that a dollar next year is not the same as a dollar right now.
- Influence of Stories. Our past experience influences our investment behavior as does what we hear from others, whether true or not. The history of our nation also plays a role.
- Corrupt and Antisocial Behavior. Corrupt and antisocial behavior of some financial professionals and how such behavior influences markets.
- Concern about fairness and how it influences financial markets.

3. Importance of Confidence

Some markets are driven in part by consumer



confidence. In the chart above we see that the bear

markets of '01 and '08 were preceded by a decline in the [Consumer Sentiment Index \(CSI\)](#). The [CSI](#) currently is favorable for the market.

Economic theory holds that a large increase in money supply stimulates. But the lack of confidence prevents lending and decreases economic activity despite the stimulus.

4. Money Illusion

The, money illusion refers to the tendency of people to think of assets in [nominal rather than real](#) terms. In other words, the face value (nominal value) of assets is considered rather than the [purchasing power](#) (real value). This is a fallacy as money has no inherent value and its real value is derived from its ability to enable the purchase of goods.

In investing and retirement planning we must always consider real value. Retirement planning is not about asset preservation; it is about [purchasing power preservation](#). Purchasing power preservation is a [particular risk](#) in fixed income (bond) investing. At 3% inflation the purchasing power of an asset decreases by 26% every 10 years.

Today a couple has a 50% chance of at least one partner living to age 95. An income stream at 60, with 3% inflation, declines by 71% by the time one spouse is 95.

5. Influence of Stories

Stories, anecdotes, and stereotypes provide you with a framework that you can rely on to understand and respond to events. You have through your lifetime, built a series of mental emotional filters to make sense of the world. The choices you make are influenced by these filters. These filters cause you to underestimate, or overestimate risk. These filters are also reflected in stocks by showing persistence in rises and falls of markets (momentum).

Whole generations who have seen the Great Depression became severely risk averse and more recently, the booming stock market lead to irrational exuberance.

6. Corrupt and Antisocial Behavior

Capitalism produces not what people need but what they want. Corrupt individuals exploit these wants, as the last three recessions have shown.

The [S&L scandal](#) was responsible for a considerable economic turmoil in the recession of 1991. S&Ls were deregulated allowing them to lend aggressively but the Deposit Insurance was left in place, a [prescription for disaster](#). When inflation rose, the cost of funds was greater than the earnings of mortgages. With proper accounting the S&Ls were bankrupt.

To acknowledge the S&L bankruptcy would have been embarrassing to the Government. Hence the Government

allowed the S&Ls to change accounting rules, allowing the S&L's to stay in business until the owners could sell them profitably. As a consequence of the S&L collapse individuals left the market.

The [Enron scandal](#) and the 2001 recession followed a similar scenario. Largely at the urging of Enron, SEC accounting rules were changed to allow Enron to overestimate its profits. As a consequence of the [Enron collapse](#) many individuals lost confidence and withdrew from the market.

The [subprime mortgage crises](#) and the current recession followed the same script. Economic institutions changed. Financial technology advanced faster than regulations. Regulations were changed to enable a modern form of snake oil.

[Subprime mortgages](#) were created and sold off as packages with the assistance of banks that saw profit opportunities. Selling this snake oil was possible since rating agencies rated them highly. This is not surprising since rating agencies are compensated by the issuer. In fact issuers can ask the agencies what their rating of a security would be. If this rating is too low, issuers will not purchase a rating. As the housing market and the economy collapsed, many individuals left the market.

Corruption arises when powerful interests can change the laws for their benefits, with disastrous consequences for the rest of us.

7. Fairness

Akerlof states that employers pay higher wages than they need to in order to get the loyal, competent, hard working workers they demand. Even when demand for workers shrinks, wages do not decrease, since this would be perceived as unfair. As a consequence, there is a greater supply than demand of workers and that leads to unemployment. This unemployment affects the economy and the markets.

8. Bottom Line

- Until confidence returns, no amount of monetary stimulus will improve stock markets.
- Money has value only by what it can purchase. Make [financial decisions based on purchasing power](#) of your investments.
- Try to resist the influences of your recent experience.
- There are always corrupt individuals. Carefully evaluate risks.

I would be glad to discuss your own investments with you.

If you have questions write to curtfey@cutfey.com.