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E.Q Trendwatch™

The history of over-confidence

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> ***"Stock Prices have reached what looks like a permanently high plateau. I do not feel there will be soon, if ever, a 50 or 60 pt. break from present levels, such as predicted. I expect to see the stock market a good deal higher within a few months."*** --Dr. Irving Fisher, Professor of Economics at Yale University, October 17th, 1929, a few weeks before the Great Crash.

The above quote is famous. It has gone down in history as one of the most painful, blindly optimistic forecasts of all time. Over the 4 years following this fateful utterance, the Dow went on to loose 89% of its market value. Okay, you might say, the guy was not a fortune-teller give him a break. Except that he was a learned economist, very influential in his day. He was one of the few people who had studied market and economic history in great detail --he held a PHD in it. He was one of the people who should have possessed some wisdom and reasonable perspective. Instead, he fell in love with recent trends and over-looked the risks at hand. His over-optimism was particularly damaging because lots of much less informed people looked up to him for leadership and guidance. Dr. Fisher and many others like him, helped to lead the nation to great financial pain.

Anyone who looks at a simple chart of the stock market action leading up to the fall of 1929 can see a remarkable parabolic peak. The Dow 30 Index spiked incredibly from 67 in 1922 to 380 in 1929. A gain of more than 467 percent in just over 6 years -an average of more than 71% per year! No wonder everyone fell in love with stocks! But for anyone learned in this field to say they did not expect a correction is truly unforgivable. In his excellent book on this era, "The Great Crash of 1929" Galbraith sagely asked, "who is to make wise those who are required to have wisdom?"

Over 6 years since the last great market peak in 2000, the masses have once again fallen blindly in love with real estate and the stock market. Inflows to mutual funds were at record levels for the year during the month of September. Recent headlines once again reflect great confidence:

> **"Dow Hits New High on Earnings Optimism. With investors favoring blue chips, analysts appeared satisfied that the market wasn't getting ahead of itself. The advance in the broader market was still narrow, and Goldman said that he expects any future sell-offs will be restrained to under a few percent." -Associated Press, October 23, 2006**

While the business media tried to hype up the significance of the Dow crossing 12,000 of late, a closer look by thoughtful people revealed not much to be excited about. Only 10 of the Dow's 30 companies are above the peak they reached at the last peak in 2000, and not one of the 30 companies within the Index was making a new high.

The significance of these weak fundamentals has not been lost on the most careful market students. We recently came across an interview that legendary money manager Sir John Templeton gave to SmartMoney magazine in April 2004. More than 2 and half years ago, Templeton explained that he was very concerned about the lack of quality investments available in the market. Since then he has repeatedly warned of the possibility of a major collapse in housing prices and stock markets:

> ***"The greatest threat to maintaining this level of economic activity is debt. There has never been a time when people worldwide, and especially in America, had such a high proportion of debt."***
>
> ***– Sir John Templeton***

Anyone following our newsletters for the past couple of years will no doubt recognize a common theme of concern about the risks presented by the over-use of credit to fuel economic expansion over the past 4 years.

In an investment world driven by selling people equities, being risk-averse at the top of a market cycle can be a lonely tour of duty. But we have to acknowledge we are among some pretty good company. Respected pension analyst and commentator John Maudlin this week wrote the following on this topic:

> ***"I have the luxury of not directly managing money. I am basically a manager of managers, so I can choose which manager (or partners I work with, who choose) to direct client money. I am really looking forward to the day when I can once again be bullish. It is so much easier both personally and professionally to have a bullish view.***
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> ***It is so vastly easier to find great managers in a bull market. And there are a lot of managers who have done well over the past few years. But if you have the view that we are going to lower valuations, putting money in long-only indexes and programs is a mug's game. It is trading short-term returns for long-term risk…If I am right and we are going into a recession or serious slowdown next year, if the market did not have a serious problem, it would be the first time in history. I don't like betting on "It's different this time." So far this year, I have been wrong; but I don't think the game is over yet. The fat lady hasn't sung."*** *-Thoughts from the Frontline, John Maudlin, Oct 27, 2006*

As professional risk managers, we at VP are paid to have wisdom in these matters. The fact that we may have looked wrong for a while now, does not dissuade us. The longer unsustainable trends persist, the more painful their unwinding. All of our objective metrics suggest that we will have an opportunity to buy these assets at cheaper prices in the not-to-distant future. Until that time, not losing money will continue to be our primary focus.

REPORT ON BUSINESS TELEVISION (ROBTV- Channel 64 on Cable)

For those that are interested, **Cory** will be the **guest Technical Analyst with Pat Bolland on *The Chart Room*, Friday November 10, at 3:30** and **Danielle** will be the **guest Portfolio Manager on *The Street* at 9:20am on Wednesday November 22.** The clips can also be viewed for the week following the appearances on the ROB website at http://www.robtv.com/shows/past_archive under past video archive for the date and time in question as well as through a link on our web home page at www.venablepark.com.