Real life needs active management

JANUARY 31 , 2011. ISSUE 1

E.Q Trendwatch™

Price takers, herds and career risk

> *"Seven habits that help produce the anything-but-efficient markets that rule the world 1. Think short term. 2. Be greedy. 3. Believe in the greater fool 4. Run with the herd. 5. Over-generalize 6. Be trendy 7. Play with other people's money."*
>
> – Paul Krugman, Economist.

Vacationing in Mexico several years ago, we considered buying a hand woven blanket at a local market. Stopping at a vendor that had several lovely samples we asked "how much for the blanket?" He looked at us for a second and said, "$100 US dollars". We had not priced these blankets before, but $100 seemed like quite a bit and so we paused for a minute, mulled it over, and stepped away. The vendor interjected "wait, special deal, for you, $90." We nodded, paused "thank you"; still seemed a little rich —we turned to move on. "Wait," he called after us, "how much do you want to pay?"

The irony of his question hung with us as we walked away. We wanted to pay fair value for the blanket. We just had no idea what that was. We didn't want to rip him off; but we didn't want to be suckers. We didn't want to pay more than it was worth. What were other people paying for these blankets? What was the going rate? Did that seem good value for us? Later that day, after a little thought (but no research) we circled back and bartered the man down to $60. Walking back to our hotel we were relieved that we had not just been price takers at a $100 but with a little patience had ended up getting our blanket at a 40% discount. A few days later, we learned that other vendors were selling similar blankets in the area for $20. Our 40% discount was instantly revealed to be a 200% premium and we felt like idiots.

There is a valuable lesson in this story for tourists. But also for those of us trying to invest. As much as we may be impatient to get on with our goals, we cannot afford to be blind "price takers". We have to do our own research and decide our own value range in advance. Once we have done our homework and defined our value range we have to be prepared to sit back and wait for that value to come to us. If the price we define is not on

Cory Venable CIM, FCSI, CMT
Technical Market Analyst

Danielle Park LL.B., CFP, CFA
Portfolio Manager

Venable Park Investment Counsel Inc.

Venable Park Investment Counsel Inc.
VPI
www.venablepark.com

33 Clapperton St.
Barrie ON L4M 3E6
Tel: (705) 792-3991
Toll Free: 866-792-3991
Fax: (705) 792-3992

offer, then we have to be prepared to stick to our rule set and wait until it does. If we choose to be "price chasers" we do so at our own peril. After we buy on our own rule set, if someone later offers to pay us much more than our price assessment suggests the item is worth, and then barring some emotional attachment, we should let them buy that asset from us.

Beach blanket parties in capital markets

The majority of participants in the stock market are blind price takers. They buy whenever they happen to get some cash and they pay whatever the market price asked is on a given day. They follow the herd, because they have not developed their own set of independent value parameters in advance. And because they are afraid to appear like they are missing out on a party with the masses, even when the masses are frequently delusional.

When it comes to professional money management, many outsiders are surprised to learn that professionals are generally as hopeless as non-professionals when it comes to herd following.

Long-time money manager and market student Jeremy Grantham of GMO explained herd following tendencies in money managers this way in his most recent market letter:

> "Remember, when it comes to the workings of the market, Keynes really got it. Career risk drives the institutional world. Basically, everyone behaves as if their job description is "keep it." Keynes explains perfectly how to keep your job: never, ever be wrong on your own. You can be wrong in company; that's okay. For example, every single CEO of, say, the 30 largest financial companies failed to see the housing bust coming and the inevitable crisis that would follow it. Naturally enough, "Nobody saw it coming!" was their cry, although we knew 30 or so strategists, economists, letter writers, and so on who all saw it coming. But in general, those who danced off the cliff had enough company that, if they didn't commit other large errors, they were safe; missing the pending crisis was far from a sufficient reason for getting fired, apparently.
>
> Keynes had it right: "A sound banker, alas, is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional and orthodox way along with his fellows, so that no one can really blame him… And if everyone is looking at everybody else to see what's going on to minimize their career risk, then we are going to have herding. We are all going to surge in one direction, and then we are all going to surge in the other direction. We are going to generate substantial momentum, which is measurable in every financial asset class, and has been so forever. Sometimes the periodicity of the momentum shifts, but it's always there. It's the single largest inefficiency in the market. There are plenty of inefficiencies, probably hundreds. But the overwhelmingly biggest one is momentum (created through a perfectly rational reason, Paul Woolley3 would say): acting to keep your job is rational. But it doesn't create an efficient market. In fact, in many ways this herding can be inefficient, even dysfunctional…"

While protecting capital from large losses through a full business cycle should be the number one focus of any valuable money manager, staying with your herd is perceived as a much safer course than independent thinking and price waiting. Grantham goes on:

> "The problem is that some of these cycles happen really fast, and some happen very slowly. And the patience of the client is three point zero zero years. If you go over that time limit, you are imperiled, and some of these cycles do indeed exceed it. You lose scads of business, as GMO did in 1998 and 1999. This timing uncertainty is what creates career and business risk."

Given the wide assortment of risks that we face in investment management, years ago at VPIC, we adopted the following investment goals in descending priority: capital preservation, income, client retention and growth.

We want to keep our clients happy, really we do! But ahead of that we must be obsessed with trying to keep their capital protected. Investing is an inherently risky business. This means that we must regularly break company with the market herd and go out on a limb of career risk. In the past four months this has caused us to miss out on the QE2 rally in stock markets. It has been hard to do and we sincerely hope that the retest needed to reveal the stability of recent prices happens soon and before our clients lose further patience. From our lens, the image that best captures the stock and commodity markets in the past four months is that of a burning building: prices burst into flames at the end of August on government-injected accelerants. The hotter and higher this burns, the more people will be enticed into the fire. But future loss and pain from this fire is a virtual certainty.

In the end, we know that we cannot control market prices, actions of Central Banks or the patience of our clients. All we can do is control ourselves, and the risk to capital that we chose to accept. Sometimes it sucks to be realists, what can we say.

The next leg of opportunity may be coming sooner than we think

Over the past 12 years, asset markets have been repeatedly injected with government stimulus and leverage to try and force prices back into the secular bull environment enjoyed in the 1980's and '90's. But a secular bear is a formidable foe. Intervention efforts have been successful for only a few years of interim rally, before the next period of inevitable reversion to the mean has reasserted its downward pull on prices.

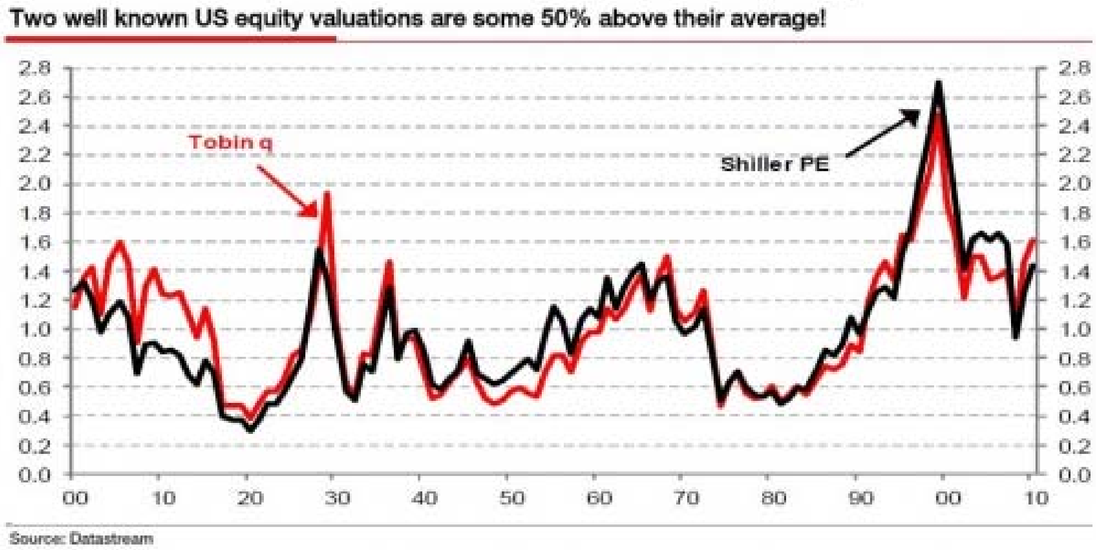
The last window of good cyclical opportunity was opened in March 2009 at the end of the 2007-2009 price implosions. Unfortunately because the natural correcting mechanism of bust, failure and bankruptcy were not permitted to wring the excess and reckless players from our system, prices roared back too quickly and the fair value window was closed again by early 2010.

QE2 has now made overbought conditions considerably worse. US equity valuations are once again (in record time of 22 months!) back some 50% above their long-term average. In emerging markets, thanks to extra inflows of speculative capital, over-valuations are even worse.

Our point can be shown in the chart below plotting two of the most reliable valuation metrics for stocks: the Shiller Price to Earnings Ratio and the Tobin q, since 1900. Today after 22 turbo-charged months, stock prices are as richly valued as they were at every other secular peak in history, third only to the year 2000 stock bubble and the notorious peak of 1929.

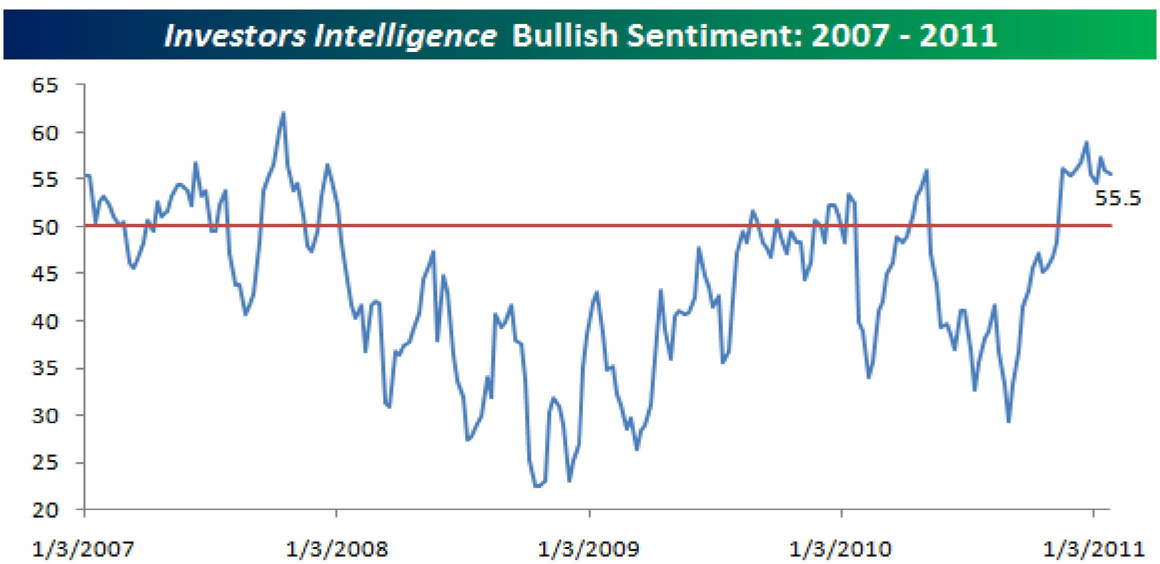
This has been the fastest round trip from massive over-valuation to fair value (we never did get to deeply discounted in March 2009) to massive over-valuation again ever in history.

Shiller PE and Tobin q valuation metrics show stocks now 50% above long-term averages



.

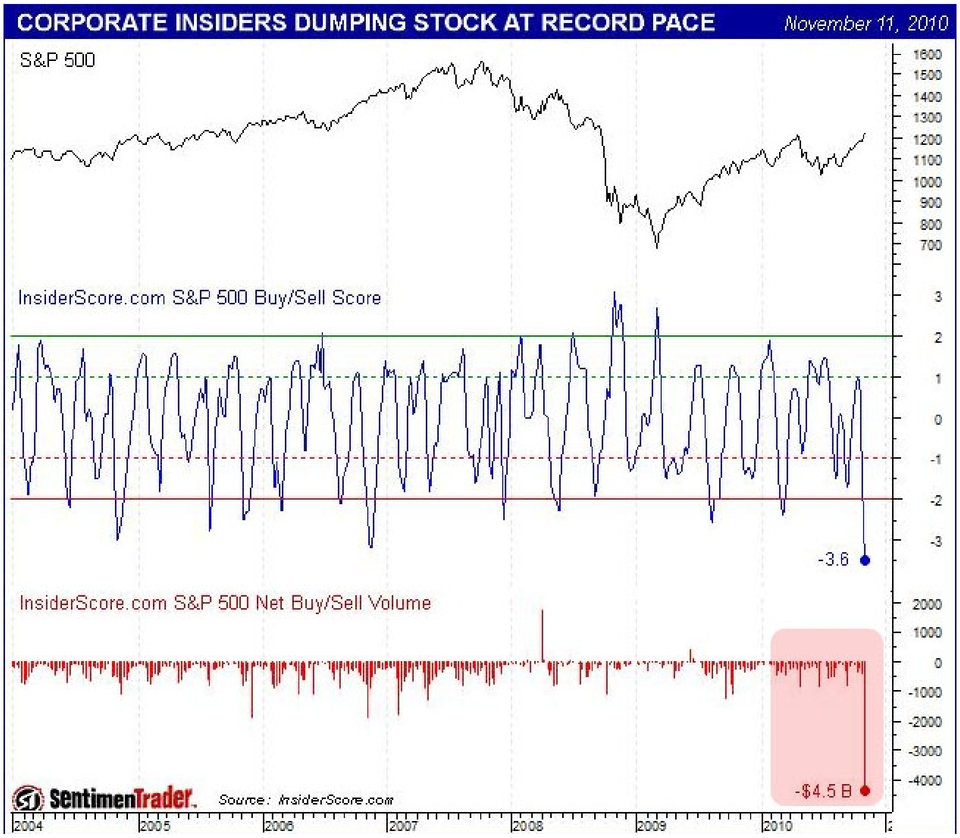
At the same time, human behaviour is in fine form with bullish sentiment predictably back at the levels of confidence and optimism last seen at the stock market peak in 2007. (see next chart)



Source: Bespoke Investment Group

At the same time, corporate insiders (rumoured to have an inside view on corporate prospects) have been cashing out with both feet, selling stock in the final quarter of 2010 at the highest volume in recorded history. (see negative ratio of buying versus selling volume plotted below)

Where are the insider's going?? What's the rush?



Not to be troubled with details, the perma-bull crowd is back living in the moment, having moved from terror less than 2 years ago, to nervousness last summer and now confident calls and aggressive allocations of late. Margin buying (an indication of aggressive risk-taking in the retail investor) increased 30% at the end of 2010 from 12 months earlier.

Right on cue, the Volatility Index (VIX, next chart) slumped back below 16 in January as investors became predictably complacent in the face of the highest stock prices (and risk) since June of 2008.

Volatility Index or “fear gauge” plunged since last May

Source: Venable Park Investment Counsel Inc.

Then just as it was least predicted, we marked a foreboding little spike in the VIX in the last couple of weeks, where the reading popped up to close above 18, and then 20 on January 28. We note that each time the VIX has drifted below 16 and then broke back above 18 over the past 4 years, it has marked an interim top for the S&P 500 followed by a period of downside contraction ranging from –17% to –55%. This plot now thickens…

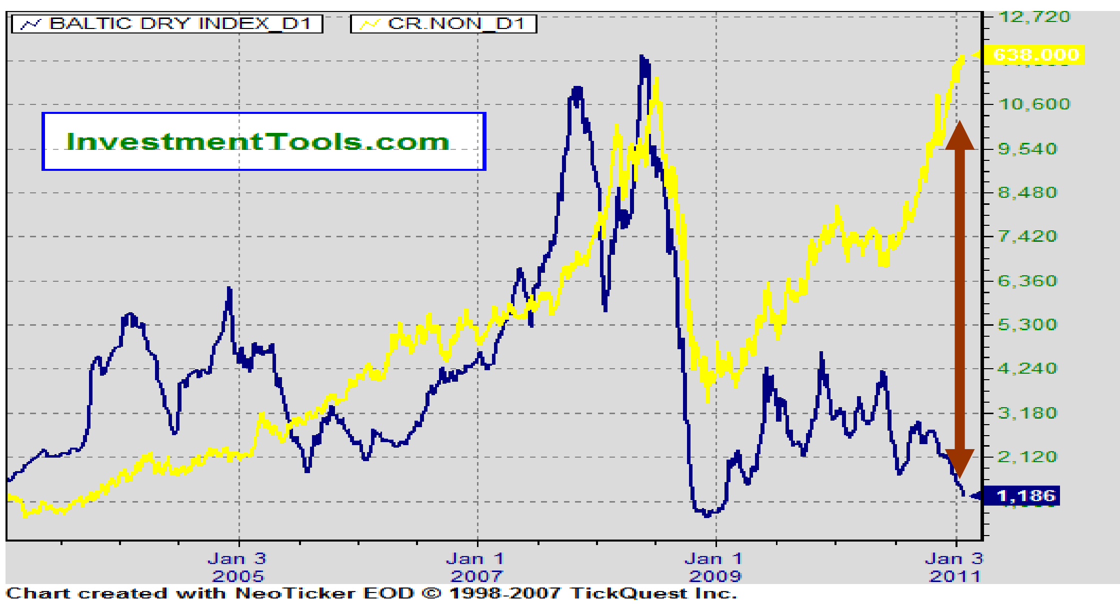
The Chinese market peaked with QE2 hopes in November and has headed back down

As we see in the next chart of the Shanghai Composite, Chinese stocks that tried to rebound this fall rolled over again in November, closing January some 22% below the last peak of August 2009. Chinese stocks tend to lead commodity prices by 6-9 months. This renewed period of weakness corresponds with the Chinese government efforts to slow their economy, prick their property bubble and curb runaway inflation in food, energy and wages. It is likely to also have a deflationary effect on commodity prices that had recently soared to the stratosphere on financial speculation and the hopes of continued strong demand in Asia.

Chinese stocks— portrait of a secular bear: stock market peaked at 6000 in 2007, fell to 1664 in late 2008 (-72%) to a peak of 3478(+100%) in August 2009, now 2752(-20%) and falling…

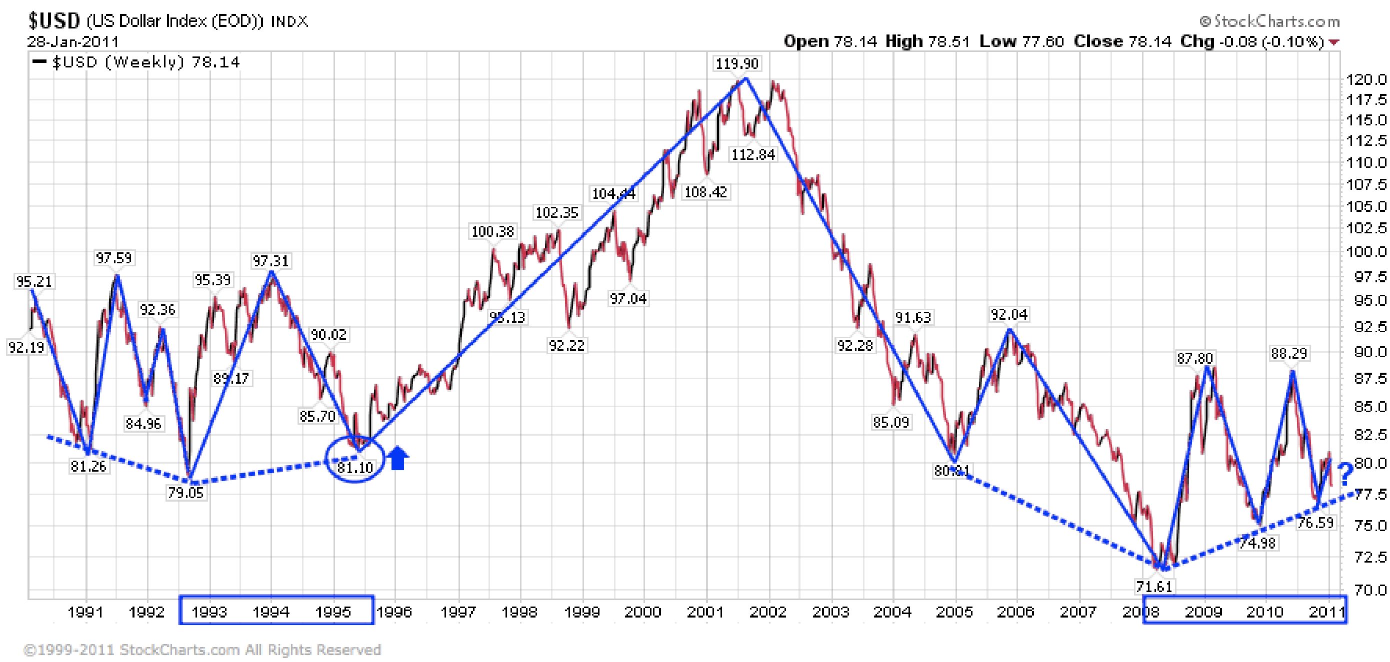
Source: Venable Park Investment Counsel Inc.

Another important barometer of world trade, the Baltic Dry Index this month plumbed the lows it reached in late 2008 in the depths of the global recession, and opened up a glaring gap (red arrow) between itself (blue line) and the CRB "Commodities Index" (yellow) below.



The dramatic divergence between shipping rates and commodity prices warns that a significant price correction in basic materials may be in the offing. This would be a particular point of weakness for the Canadian economy, stock market and C$ dollar.

The US dollar Index still holding in, despite all its headwinds



Source: Venable Park Investment Counsel Inc.

Defying the consensus view, the US dollar (chart above) has so far managed to hold a bullish trend line of higher lows since it bottomed in mid 2008. For those calling for its imminent collapse we simply note that the U$ Index already fell in value 40% from its peak in 2001, to the low of 2008. We also note (marked in blue rectangles at the bottom above) that it took three years (1993-1996) for the U$ to bottom and finally break out to the upside in 2006. Against a basket of world currencies, the green back is so far still the relative preference for safe-haven inflows. It seems that this preference is likely to continue with added force once the next risk down cycle begins in earnest.

Global credit woes are so ubiquitous today it is difficult to say longer term, which currencies will end up ahead relative to one another. As we saw this month with Japan, sovereign credit downgrades are coming. The US may well be downgraded from AAA in the not too distant future. But these issues are already well known. Currency moving events from here are more likely to be dependent on risk appetite swings and 'surprise' developments in government policies around spending cuts and which defaults are permitted in government obligations. The quickest way to get out of debt is to default. In this theme, we are very interested to see the outcome of the newly called Irish election that has been slated for February 25.

Last November Irish government made the mistake of promising to backstop all of the Irish bank bondholders. This was actually an impractical plan as the bondholder debt far exceeds the economic output of the entire country. The Irish people who are suffering through the worst economic conditions in 60 years rejected the tax-payer funded bailout of bondholders (bondholders after all, who agreed to take the risk of loaning money for interest payments in return; didn't they realize their was risk involved? Aren't bondholders supposed to be the sophisticated ones?) The new election is likely to endorse leaders against the bond bailout. Once this precedent is set, we think that other countries, municipalities and states may begin to follow suit, or use the threat of default as a way to force restructuring of their debt obligations. This is a nice way to say the bondholders will take some losses and debt will be written down. In the real world, debts that cannot be repaid just won't. It has always been thus.

US Long Bonds still holding in long-term upward bias since 2006

Source: Venable Park Investment Counsel Inc.

As the US Federal Government backs away from emergency subsidies it has been giving to states and municipalities the past few years, as well as the impossible promises it has made to fund social security and other entitlements, its deficits will decline and its fiscal health will improve. We aren't saying this will be pleasant for the American people (or those in all the other counties facing austerity cuts today) but spending that can't be funded will end. Maybe this is why the US long bond (shown above) has proven resilient over the past 5 years. America has been over-spending and over-borrowing, no question. But the world needs its biggest economy to rehabilitate and come back to spend another day. As hard as it may be to imagine fiscal health in the future, history tells us that credit cycles do run full circle and balanced budgets and repaired balance sheets will arrive again some day - probably sooner than any of us can imagine.

A word on annual return comparisons: more to it than meets the eye

This month the Globe ran with a story on the CPP fund and how it had managed to earn 10.4% in 2010. Most people reading this may well be impressed. Some closer consideration however reveals an important point most often overlooked. The article pointed out that over the past decade the CPP had averaged an annual return of 5.4%, slightly over half its one year headline. This tells us something. The CPP fund with all its incredible advantages of size, access, experts, enormous inflows, infinite time horizons, economies of scale and the lowest execution costs in the marketplace, has averaged 5.4% a year over the past decade.

The reason that this fund and most others like it, made 10% in 2010 is actually the same reason that they suffer large draw-downs in every bear market. The answer is that they are constantly long the stock market. They ride it up and then ride it down, year after year. Each time they have a negative year (which happens once or twice every 5 year cycle) they give back large chunks of their previous up market gains. The end result is significant volatility for fairly modest gross returns of 5%. The next negative year will take their 10, 5, 3 and 1 year average return down further.

It has become popular of late to denounce "buy and hold" as a strategy since that has been so painful for people over the past 12 years. But rather than devise a more useful tactical approach, we note that the financial industry is now marketing "asset allocation" as the answer. We wish it were that easy! In fact "asset allocation" is just semantics for the same old passive allocation to risk assets under a different moniker. Stock and commodity markets around the world are risk assets by any name. In our modern day of globalization and integrated markets, correlations all trade to one in downturns, so consuming different flavours of the same poison really isn't meaningful risk management.

Recent developments:

Civil revolts in Tunisia and Egypt this month underline the real world costs of quantitative easing and lax government policies that promote speculation in commodities and financial markets. Commodities are priced in dollars, and the US Fed has been flooding the world with dollars for the last two years. As a result, emerging markets and the food sector in particular are suffering spiking inflation.

The CRB food index is up 36 percent over the past year, and 8 percent this month alone. Raw materials are up 23 percent over the past year. Stress from inflation is being felt all over China, broader Asia, India, Africa, South and Central America. Even British and German inflation are flashing red of late.

The QE2 pop in financial markets last quarter left asset prices precariously priced for perfection. Perfection is far from reality in the world economy today. Any exogenous shock such as further housing weakness, further bank losses, a resurgence in unemployment or political unrest and contagion in any of the many stressed regions of the world today could provide the tipping point to topple recently over-confident markets.

If recent indicators are valid, a meaningful correction phase may already be underway. We look to add our next wave of income bearing equities as prices come to us.

Best wishes for February!

Quotes of the Month:

> **"…most people have trouble doing mathematical calculations…we aren't built to do mathematical calculations, and relatively simple problems trip up MIT rocket scientists. The news gets even worse. The second big problem we face in investing is that we are systematically overconfident. We are bad at doing the calculations required to analyse investments, and simultaneously we are unaware of our shortcomings."**
>
> --Terry Burnham, "Mean Markets and Lizard Brains (2005)"

> ***"Creativity requires the courage to let go of certainties."*** —Erich Fromm 1900-1980, Psychologist

Don't forget to visit our market blog www.jugglingdynamite.com for weekly commentary, articles and media clips