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Decision Time

Since the beginning of the year, economists have been celebrating the new conventional wisdom: *the so-called recession never actually happened… but even if it did, don't worry: the recovery is underway.* And the media, as always, is serving as a megaphone for this chorus of expert opinion, transforming mere optimism into downright giddiness.

Despite the sanguinity of economists, you may notice a discordant note in their otherwise cheerful tone: in spite an abundance of confidence about the *direction* of the economy (up), there is a fairly pervasive pessimism about the likely *strength* of the recovery (weak).

It is not uncommon to detect this kind of duality in the consensus of experts. After all, many animals travel in packs for protection, and humans are no exception. Remaining with the group is especially important for a high-profile economist, analyst, or fund manager trying to protect his or her reputation (or job) in uncertain times.

For a financial professional to predict more gloom-and-doom in the face of the undeniably-strong leading economic indicators we have been seeing lately would be a risky bet indeed. After all, it is hard to argue with the jump in nonfarm payrolls, increasing durable goods orders, the upward revision of Q4 productivity, rising factory orders and manufacturing activity, and falling inventory-to-sales ratios (to name just a few).

But why get *too* ebullient about the recovery and appear to be Pollyannaish compared to your more sober colleagues? Better to remain comfortably in the middle of the pack – at least you won't stand out if you are wrong.

One thing you can be sure of: they *are* wrong. In the previous two issues of *fcNOTES* (January 31 and February 28), we showed you how we use the media as a proxy for consensus opinion and why the consensus is a reliable contrarian indicator for investment decisions: It's what the experts don't see (and the media therefore cannot report) that moves markets, not what everyone already knows.

Right now, everyone knows that the economy is heating up. So the current prices of stocks already reflect that knowledge. The question is, what is the most likely surprise that will move stocks higher or lower from here? In other words, which *part* of the current consensus about the future direction and strength of the economy is wrong? Is the economy going to get worse in the near future, defying the predictions of even the most conservative forecasters? Or is it going to get *much* better than anyone expects?

In this month's letter, we are going to explain how we make decisions (and watch our backs) when faced with this kind of dual consensus. Whether or not you agree with our methods, we encourage all of our readers to define for themselves the five crucial "decision categories" that should be a part of everyone's portfolio management discipline.

The first decision category is ***strategic***, the method by which an investor forms her big-picture outlook and develops an investment approach to maximize returns if that outlook proves correct. The second is ***policy***, the rules the investor creates to protect himself from a devastating loss of principal if his outlook proves incorrect. The third is ***tactical***, the flexible investment decisions made in real time given supply-and-demand conditions in the market. The fourth is ***emotional***, the process by which the investor decides when she is wrong and cuts her losses. The fifth and final decision category is ***measurement***, how the investor determines whether or not all of his other decisions are working and what changes need to be made to improve his results.

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1. Strategic Decisions – *"Intelligent Contrarianism"*

Strategy – getting the big picture right – is the most important contributor to investment success.

The carnage in the technology sector over the past two years is an excellent example of this. Even the best technology companies have seen the price of their shares decline precipitously. Intel, for example, is trading in the $30 area today down from a split-adjusted $70 in March of 2000. Intel is a profitable company with dominant market share and terrific management, but the stock has nonetheless lost more than 50% of it's value over the past two years. And remember: it takes a 100% gain to recover a 50% loss. If you purchased Intel at $70 a couple years ago and have refused to sell it because you are a "long-term" investor, how long will you have to wait just to break even? According to Ibbotson Associates, stocks have gained approximately 11% a year during the past 75 years. Even if we assume that Intel will do better than the average stock (say, 15% a year), it will still take *more than six years* before Intel gets back to $70.

Our strategic approach to understanding the big picture is what we call "intelligent contrarianism." What makes it "intelligent" is that it is not simply doing the opposite of what other investors are doing, but rather locating "breaks" in the conventional wisdom and then using a variety of methods to decide which break represents the most probable outcome.

The reason this approach works is that the stock market is an incredibly efficient discounter of all known information. Proponents of the "random walk" theory of investing will tell you that it is impossible to beat the market over the long term, since there is no way you can process information faster than the market (unless you are doing something illegal to get that information before it is available to all market participants).

They are right about the first part; because all known opportunities and risks are priced into securities long before you read about them, you cannot consistently profit by buying on good news or selling on bad news. As we described in the last two issues of *fcNOTES*, the market has already priced in the worst-case scenarios of what we are all worried about (examples: terrorism or Enron) or the best-case scenarios for what we are all excited about (examples: the Internet revolution in the late 90s), so buying or selling stocks based on these outlooks is a fool's game... *unless* you turn the logic of efficient markets on its head.

Intelligent contrarianism does just that. If expert opinion (consensus) is already priced into stocks, and if it is unlikely that stock prices will not move at all (when was the last time you saw a long, smooth line on any stock chart?), you can reasonably conclude that something *other* than what the experts predict has to happen. Surprises move markets, not what everyone already knows. If the consensus is overwhelmingly positive, the most likely surprise is negative. If the consensus is extremely negative, then expect stocks to move up soon in advance of good news.

But what if there is more than one consensus? It is not uncommon for expert opinions to "bunch up" at more than point. As we observed in the introduction of this letter, a clear consensus has emerged that the recession is over (or never happened at all), that the recovery is underway, and that stocks are likely to do better within this improving economic environment. An obvious surprise (and thus a real possibility) is that stocks will fall in spite of the positive economic news, perhaps helping to drag our economy into a "double-dip" recession.

At the same time, a secondary consensus has emerged on the back of the primary consensus: with the exception of those who have been bullish (and wrong) throughout the long decline, many of the experts who predict recovery are warning that it is likely to be relatively weak (or "moderately paced," as one voting Fed president recently put it). So another way that the market could surprise (and again prove the experts wrong) is by really taking off, pushing stocks up 40% or more by the end of the year. After all, even the most optimistic forecasters don't predict that.

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We think the former is more likely (a continuation of the bear market and a double-dip recession), primarily because there are so many short-term bullish signs – and that is bearish. But what if the other possible surprise happens, and the market takes off from here without looking back? How do we protect ourselves in case *we* are the ones who are wrong?

2. Policy Decisions – *Rules*

Policy refers to the set of rules that you create – *before* making investment decisions – to protect yourself from your own worst enemy… yourself. Effective portfolio management policies seek to minimize the emotional element that can cause you to make bad choices in stressful times by making decisions for certain situations *before those situations occur.*

A good example of this is the stop order (often referred to as a stop-loss order). A stop order is an open-ended order that you place with your broker to buy or sell a stock only if it trades at a specified price. For example, if we buy 1000 shares of Intel at 30, and if one of our rules is to never allow a position to lose more than 7%, then we would place a stop order to sell 1000 shares of Intel at 27.9. This order remains dormant unless Intel trades at 27.9. When that happens, it becomes a market order, meaning that it will be executed at the best price possible (but not necessarily at the stop price).

Without a stop order, it is easy to rationalize not selling out a position. How many of us have held onto a loser, telling ourselves that we will wait to "break even" before we unload it? That's just human nature: we love the feeling that accompanies selling something for a profit, and we loathe the emotion that goes along with selling at a loss. Putting a stop order in place before these emotions influence your thinking protects you from holding onto a loser longer than you should.

In addition to using stops for every position we enter, we have three, broad risk-management policies. First, we always hold both long and short equity positions (periodically shifting the long/short target ratio to address changing market conditions in real time). We believe that maintaining such a "counterstrategic ratio" of short-to-long equity positions in strong markets and long-to-short equity positions in weak markets is the best way to protect our portfolio against the loss of capital that can accompany sudden and unexpected changes in financial markets. While this approach does not always achieve the maximum possible return (and can create a substantial amount of "performance drag" in runaway bull markets), it can afford us significant protection if our primary strategies are proven wrong by the markets.

Second, we employ an active hedging strategy at all times, using futures and/or options to hedge our primary investment strategies and to "smooth out" the underlying price volatility of our core long/short equity portfolio.

Third, we adhere to a strict portfolio-wide stop-loss discipline to protect against an overwhelming loss of capital. Our policy is to close *all* positions if our portfolio loses more than 10% (versus prior month-end) in a single calendar month. We have found that the process of "going flat" creates a clarity of vision that is difficult to achieve given the emotional connection between open positions and market activity.

Your policies might be different than ours. That's fine. There's no such thing as "one size fits all" when it comes to investing. But whatever your rules, make sure you stick to them, no matter what your emotions are telling you. To do anything else is just gambling.

3. Tactical Decisions – *Flexibility*

A strategy based on "intelligent contrarianism" demands a flexible approach to investing; as the consensus opinion changes, our investment approach must be adjusted accordingly.

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But there is another good reason to remain flexible in your approach to investing regardless of how you form your investment strategies: supply and demand.

The stock market is just that – a market. The products being sold are the stocks themselves, and the same rules of supply and demand that impact markets for goods and services apply to markets for securities. When a sector becomes "hot," it means that demand for that type of stock is increasing. And as is the case in other markets, when demand for a particular product increases, suppliers rush to satisfy the demand and capture the high prices. In the case of the stock market, the suppliers are the venture capitalists and investment bankers who fund new companies and take them public. The best recent illustration of the internal supply/demand dynamic in the stock markets is, of course, the Internet bubble. Since demand for Internet stocks was so high, VCs and investment bankers scrambled to take anything public that had a "dot.com" name attached to it, even companies that had no chance of ever becoming profitable.

As a result, the supply of Internet companies grew dramatically, eventually causing prices to decline and then crash, as the demand for these stocks disappeared. But while Internet stocks were hot, boring "old-economy" (i.e.—profitable) companies were not. Thus, fewer non-tech companies were taken public, keeping the supply low and setting the stage for increasing prices when demand for old-economy names came back in the wake of the dot.com implosion.

In the last issue of *fcNOTES*, we observed that all market capitalization weighted stock market indexes in the U.S. and other developed nations tend to have similar returns over very long periods of time (about three decades). Supply and demand explains why.

It is in the stocks with the greatest deviations from the long-term mean where the most opportunity exists, be it on the short side or the long side: Internet stocks had to decline dramatically at some point to revert to the long-term average, just as Japanese stocks will have to rise at some point for the same reason. Knowing this won't make you any money or protect you from losses in and of itself, but if you can develop a strategy for timing your entry and exit in to certain sectors (ours is intelligent contrarianism) with the understanding that no one company type, sector, or even country will always represent the best investment opportunity, then you have the foundation for market-beating performance in every kind of market.

4. Emotional Decisions – *Humility*

It is impossible to make a decision without some emotion. For example, when we can't solve a problem, we get angry and frustrated, and that anger influences our decisions. Likewise, when we experience success, we feel elated and more confident (perhaps the reason why so many traders tend to make their worst trading decisions immediately after their best trades).

The ability to admit mistakes is a sign of wisdom, but many investors in the face of difficult markets find wisdom difficult to achieve. To admit that a particular investment decision may be incomplete or just plain wrong is to cast doubt on all the assumptions that underlie your strategy.

Self-protection – the need to preserve a sense of our own competence – is the fundamental reason why we have difficulty admitting to ourselves, much less others, that despite our best intentions, we have failed.

But as an investor, what would you rather protect: your feelings or your net worth?

If you care more about making money than you do about being right, then we encourage you to be humble when it comes to investing. Humility is fundamental to good emotional decision making. Like the gods of ancient Greece, those the markets would destroy they first make proud.

So how do you minimize the impact of your own emotions? First, you establish risk-management rules and then stick to them (policy). Second, you never make an investment decision without also identifying what has to happen to prove you wrong. As we wrote last year (December 30), "if the S&P 500 and the Dow can break out above their respective 200-day moving averages and stay there for a few weeks (as the Nasdaq has already done), then we will most likely throw in the towel and start buying stocks." So though we remain bearish on the U.S. markets, we are well aware of the fact that the Dow is trading comfortably above the 200-day SMA, while the Nasdaq and S&P 500 are vacillating right around their respective 200-day levels.

There is nothing magical about the 200-day SMA. Some might argue for using a different technical indicator in this situation. That's fine. The important part is that you identify and watch something specific and tangible that will remind you to swallow your pride, get out, and take a second look (before you really get hurt).

5. Measurement Decisions – *"Real" Performance*

Successful investing depends on replacing the emotional need to "feel good" about decisions with the intellectual discipline to understand them. Understanding your investment decisions – what worked, what didn't, and why – is the final decision category: Measurement.

Most mutual fund managers compare their results to a benchmark, such as a well-known index. In our view, there is nothing wrong with using a benchmark to measure your performance if your goal is to outperform other investors in a particular sector. For example, if you live in the Silicon Valley and think you are very good at picking tech stocks, you might compare your performance with the technology-dominated Nasdaq. If your portfolio is up 25% during a period when the Nasdaq rises 40%, then you should probably revamp your strategies and methods.

The objection we have to using a benchmark, however, is that it can be used to rationalize losing money. Case in point: A recent article in the Wall Street Journal about Morningstar's ratings of mutual funds pointed out that "a fund can land in the top echelon because it lost less money than others in the same broad grouping of funds. One-third of the U.S.-stock funds with a five-star Morningstar rating had negative returns for the 12-months through February."

We would suggest an alternative to managing against a benchmark: *making money*, or what we call "real" performance. Our goal is long-term consistent profitability, not beating an index. As we pointed out earlier, the risk management approach that we have adopted can lead to underperformance against a broad index in very strong bull markets, but we have accepted this as a consequence of having a strategy that makes money in every kind of market.

After all, that's what pays the bills.

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PS – Since the start of the year, the Dow has risen 3.8%, but the Nasdaq has slipped 5.4% – a wash. You haven't missed out on anything by taking our advice to avoid equities, in spite of the pressure "to get back in" that you may be feeling from the media coverage of the economic recovery. In a situation like this, ask yourself who is more worthy of your trust: the media or the markets? The former gives you hype and hysteria; the latter delivers efficient pricing of all known information. In spite of the good economic news, the markets have been flat. We can't rule out a new bull market at this point, but we will wait for the market to tell us, not the media. Our guess is that there will come a time, possibly later this year, when we see the reverse: the media will become increasingly pessimistic while the markets rise in the face of bad news. That will be the time to buy.

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