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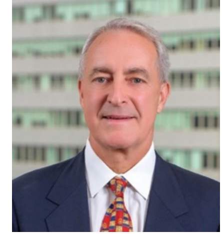

Thoughts for Investors

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The role of statistics on investor happiness

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"In investing, what is comfortable is rarely profitable"
– Robert Arnott, investor

Investors, are you happy yet? A common answer seems to be a half-hearted "I think so." 2013 was a strong year for stocks with the S&P 500 up about 30%. Yet no one seems to be really happy. Rather they are skeptical about the stock market's rise. Why? The big reasons seem to be first, that investors do not believe the market deserves to be up so much. We read multiple reports that worldwide economic growth is anemic, in part, due to a lack of corporate investment. Second, and maybe more importantly, some investors worry there will be a big correction and the stock market rise will "end badly" because of "government spending" and "money printing." Statistics seem to support these concerns, or so it seems. In this newsletter I will explore the prominent role that statistics, fortified by the memories of past bear markets, plays on investor happiness and therefore their decisions. I will also address whether investors should use statistics as indicators of the time to sell.

"Wall Street climbs a wall of worry"
– Old Wall Street saying

Normally there is enough time between bear markets to heal, or rather to forget; but not this time. I remember the "Crash of 1987" but not the "Bear Market of 1973-1974" partly because I was happily insulated in college at the time and partly because more than 13 years separated the two market declines. Many investors were caught off guard by the bursting of the "Tech Bubble" in 1999 because the "Crash of '87" had occurred 12 years earlier. It was easy to forget because they were either not old enough to care or did not have as much money at risk at the time. But the bear market of 2008 was only six years removed from the bear market of 2002, so few investors had time to forget. 2014 is also only six years removed from 2008. Add to this the never-ending flow of statistics (and graphs) acting as reminders and it seems natural to think that this year may not be a good one for the stock market. Despite 2014 starting off rocky, I continue to remind investors that 2013 (and 2014 so far) is missing one very big component necessary to extinguish the bull market and ignite a bear market—euphoria.

The great value investor John Templeton observed that, "Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria." Is anyone feeling euphoric about the stock market (or the economy) right now? Notice Templeton never mentions PE ratios, politics or government statistics as markers of the stock market's position in its cycle. I believe there are still plenty of skeptical investors (and even one or two downright pessimistic ones) still around. That should be a good sign for the stock market. Another sign the end is probably not yet near is when pundits talk about the existence of a "stock market bubble" and many investors nod in agreement. In contrast, the end is usually close when these same comments meet with dismissal or even ridicule. Still, with statistics pointing to anemic economic and employment growth in U.S. and world economies, how can one justify this market's rise? That's going to take a little more time to explain because statistics don't tell the whole story.

"Not everything that can be counted counts and not

everything that counts can be counted"

– Albert Einstein

I believe investors can often be divided into two general categories based on how they make investment decisions: "top-down" or "bottom-up." "Top-down" investors rely heavily on statistics about where factors such as inflation and interest rates are headed or broad themes such as "renewable energy." But should dependence on themes or broad economic statistics constitute the primary basis for decisions by investors? Are these statistics really accurate arbiters when their calculation involves so many assumptions which themselves need to be accurately calculated? Further, most calculations of economic statistics almost always exclude the "underground economy" or factors that may not yet "appear on the radar screen" of the government statisticians. Finally, government statistics are continually being revised even after they have already affected the market.

The opposite approach to "top-down" investing is to make decisions based on the opportunities and conditions of specific companies and their stocks. This is called "bottom-up" or "fundamental" investing and is predominantly my approach to managing client portfolios. Both approaches have value, yet I believe the complexity of accurately calculating broad economic statistics along with the necessity for revisions should make "top-down" investing a complement to, rather than the basis of investment decisions.

As an example of a shortcoming of "top-down" investing, look at the history of the cellular telephone and its effect on inflation, the economy and by extension, investor happiness. Inflation in the U.S. is measured by a government statistic called the Consumer Price Index or CPI. In 1999, Jerry Hausman of the Department of Economics of MIT wrote an article in the Journal of Business & Economic Statistics. He explained that cellular telephones originally sold for about $3000 in 1983. By 1998 the cell phone was already an important part of the economy. Approximately 20% of Americans had one and the price was down to about $200. This 90% price decline positively offset inflation in other goods and services for many years. Yet Hausman points out, "The Bureau of Labor Statistics did not know that cellular telephones existed, at least in terms of calculating the Consumer Price Index, until 1998, when they were finally included in the CPI." The omission of the cellphone in the CPI calculation for 15 years meant both that inflation was overstated and the cell phone's effect on the economy was understated during that period. How much and to what degree did that omission incorrectly influence "top-down" investors' happiness and their decisions? In contrast, "bottom-up" investors had identified opportunities in cell phone related companies and invested in them long before 1998.

"The circulation of confidence is more important than the circulation of money"

– President James Madison

Today, the "smartphone" is the successor to the cell phone. How accurately is the smartphone's economic effect reflected in government statistics? Over decades, I have seen "top-down" investors suffer "paralysis by analysis" because of what I believe to be their inability to "connect the dots" for an overall picture of the state of the economy before they gain the confidence to act. They wait for announcements about the Trade Deficit, the Budget Deficit, the M1 Money Supply, Exports, Imports, the Dollar, the Unemployment Rate, Durable Goods and countless other statistics whose importance waxes and wanes.

"You can't connect the dots looking forward; you can only connect them looking backward"

– Steve Jobs

"Connecting the dots" to form an overall picture of the state of the economy is the purpose of government statistical calculations. Investors love when everything can be neatly connected because it is usually easier to understand. Many tend to accept statistics at face value even if they are backward looking, require many

assumptions and are constantly revised. Yet predicting the forward economic impact of things like smartphones may be like a sharpshooter aiming at a target a mile away, the slightest twitch or shift in the wind can result in a very wide miss.

"Bottom-up" investing on the other hand is hard work and therefore, I believe many investors give up in frustration. There is usually no easy "dot connecting" between healthcare, energy and trucking in order to neatly wrap everything up into one decision. "Bottom-up" investing requires researching each company and making individual decisions. The great thing about this is that one can often uncover opportunities well before they surface in a statistic.

If you believe in the Efficient Market Theory,2 which basically states that the market learns, processes and digests all information accurately, then the stock market's rise over the last few years is warranted and by definition there can be no "bubble." Is it possible that the appreciation of so many individual stocks in the stock market is telling us there is more growth coming than we can see by backward looking pronouncements of GDP and other statistics? This leads to the question of whether 2014 is also the time to sell. As I have outlined in previous newsletters, I believe there are four reasons to sell: 1. You need the money; 2. The fundamentals of a company are deteriorating; 3. You made a mistake in your analysis; or 4. You found a better opportunity. In my opinion, selling because of past or potentially misleading future statistics, or bad memories, is not a sound investment process and can lead to investment mistakes.

"The stock market is filled with individuals who know the price of everything, but the value of nothing"

– Phillip Fisher

In summary, I don't know whether 2014 is a time to sell (and I'm sorry to make you read to the end of this newsletter to find that out). Though if you still feel unhappy, nervous, skeptical or downright pessimistic instead of euphoric, then in my opinion, the end of the bull market is not yet here. I also believe that if you are truly interested in investing as opposed to speculating, your decisions to buy and sell should first and foremost be based on sound research about the fundamentals of a company and their prospects for future growth. The latest pronouncements on the unemployment rate, inflation rate or some other government economic statistic are too widely dispersed and often initially incorrect yet irresistible. Thus, I believe the use of government statistics should only serve as a complement to fundamental investing and never as the basis for decision-making or investor happiness.

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