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EAM November, 2010 Newsletter

WEAPONS
of
MASS POVERTY

"A heap of trouble for those expecting [historic bond returns]… lies ahead"

- Bill Gross, PIMCO Investments, October, 2010.[3]

(Gross is one of the most respected bond investors of our time)

In this issue EAM's Mark Elliott shares his beliefs on why:

- **Popular financial planning strategies invariably fail**
- **Investment theories may *cause* investment bubbles**
- **The *most dangerous* – and avoidable – financial disaster *is now underway***
- **Retirees and Baby Boomers among those most at risk**
- **Investors should act <u>now</u> to avoid a financial disaster that appears more obvious than the real estate and tech bubbles were**

"The investment planning formulas and dogmas on which we base our most important financial decisions, through the mere process of gaining near-universal acceptance, end up fostering, amplifying, and even creating modern asset bubbles. As such they are the insidious smoking guns; the weapons of mass poverty that win the hearts and minds of investors; that have precipitated the formation of at least *three* asset bubbles during an information-packed decade that theoretically should have produced *none*."

The Danger Is Real and the Time to Act is *Now*

I believe what could be the most serious catastrophe to face retirees and other investors since The Great Depression may be currently underway and, as in past recent financial catastrophes, most investors and financial "professionals" will fail to act – despite what appears to be clear writing on the wall.

The fact that I am vocally prophesying what I believe will be our *third* financial crisis in just over a decade[1] led me to consider the nature of these disasters. How can we possibly have 3 asset bubbles in the course of a decade in an era when more investors than ever are educated with every bit of information that was unimaginable 20 years ago? If an educated market is a rational market then we shouldn't have had *one* asset bubble, let alone *three*[2]. Something fundamental must be wrong – and it must be being overlooked by virtually everyone in the investment world.

My answer to the problem surprised even me, but it makes so much sense I cannot understand why I haven't heard about it elsewhere: the foundations on which the financial planning industry is based upon are fundamentally, terminally, and irreparably flawed. The investment planning formulas and dogmas on which we base our most important financial decisions, through the mere process of gaining near-universal acceptance, end up fostering, amplifying, and even creating modern asset bubbles. As such they are the insidious smoking guns; the weapons of mass poverty that win the hearts and minds of investors; that have precipitated the formation of at least *three* asset bubbles during an information-packed decade that should have produced *none*.

Perhaps in our age we have too much information more inclined to ignore the data altogether. We look to these systems, and the institutions behind them, to make investment decisions for us because we are overloaded with information. I believe that is why today we more inclined to ignore fundamental investment data in our quest for investment systems, theories, and "rules of thumbs" that simplify our investment decisions[3]. I believe those very systems that were created to simplify our investment and financial planning decisions have become bigger nightmares than the information overload ever was.

Whatever happened to "past performance is not indicative of future returns"?

The whole basis of the financial planning profession is based on two clearly incompatible notions. Financial Planners warn against making investment decisions based on past performance while, often in

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[1] As always, I hope *this* time I am *wrong*

[2] I could argue *four* as I also sounded alarms about oil prices near their peak, though not as vocally as I did with tech stocks, real estate, and now bond markets and the effect of the brief spike in oil prices was minimal except for those who made poorly-timed speculative trades or traded in their SUVs.

[3] This could also explain the stratospheric growth of the financial planning industry despite data suggesting the typical investment manager performs worse than choosing investments by throwing darts at a wall of ticker symbols.

the same breath, advocating investment plans based on investment planning theory that is often solely based upon analysis of past market return patterns. As advisors and investors act on these accepted "rules" (backed by *past performance*) they cease making logical decisions based on observable *current* market data. These theories become so entrenched in our popular culture that questioning them becomes almost unthinkable and unspeakable (even when the data is so strong that it seems blatantly obvious, in retrospect, after the bubble has burst) and therefore these investment dogmas allow the formation of asset bubbles where otherwise they would not occur. Ironically the theories that the entire financial planning industry relies upon serve as a cornerstone for the creation of modern financial crises.

To illustrate that fact let's explore the most recent investment market bubbles and the investment theories and dogmas which I argue were fundamentally and inseparably responsible for the amplification and/or creation of those asset bubbles. In my opinion the clearest evidence of investment theories *causing* investment bubbles through by gaining near-universal acceptance is the recent market run-up and implosion of the residential real estate market.

The Real Estate Bubble in Perspective

The real estate bubble was created *not* by greedy banks and investors (though of course they helped) it was *created* by *ideas* – ideas that gained almost universal acceptance that elevated them to the status of investment dogma and therefore giving the power to become the true root cause of the recent market meltdown. These ideas were based on models created by leading mathematicians that assumed (based on past data) housing prices would never drop by more than a certain amount and homeowners wouldn't walk away from their homes in appreciable numbers. These models were based on such solid and stringent *back-testing* that they gained near universal acceptance: investors believed in the models so much they ignored real estate market fundamentals as they blindly funneled more money into subprime mortgages. Rating agencies also saw the strength of the mathematical formulas based on past data and blessed many of the securities backed by those mortgages with rock-solid AAA ratings. The data was unarguably sound, but acting on past data distorted the market by adding additional liquidity to the housing markets that *caused* that very investment dogma to *become* invalid – and in the process turned the theories supported by the observed past data into a weapon of mass poverty. Investment professionals must learn that just because a "statistically significant[4]" pattern can be found in past data *doesn't mean* one can achieve future profits by acting on that data. Perhaps quite the opposite is more likely to be true.

Amplifying the real estate bubble was the fact that the real estate investment dogmas of Wall Street were augmented by those held on Main Street. "Everyone *knows* to get ahead financially the first and best thing you can do is buy a home" and "if you are going to live somewhere for more than 4 years it is better to buy, not rent." Those principles were so widely adhered to that the few people who dared argue against them were often openly and publicly ridiculed, including yours truly. After telling people I was not planning to buy a home in San Diego in 2004-2008 people would often tersely reply "you must be a terrible advisor… you clearly have no idea what you are talking about!" Now those same individuals who previously vehemently labeled me an idiot inform me *anyone* could have seen it coming. Whether I am an idiot or not will always be up for debate, but the fact that anyone could have seen the real estate investment bubble coming I wholeheartedly believe to be true. Yet the problem wasn't with the real estate market per se as it was the universal acceptance of an investment dogma. After the real estate crash both professional and amateur investors alike simply threw out the investment theories related to *real estate* and found others to follow, just as they did after the tech market crash… and the cycle of foolishness continues unabated today.

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[4] Statistical significance is not equivalent to "facts." Statistical significance is simply a mathematical method of determining the likelihood of a series of data not being attributable to change. However if thousands of people toss a coin 20 times each to test if they have special powers to influence the coin, some will achieve "statistically relevant" results *by chance*. I argue that in the case of investing by acting on the results of past tests actually makes the data completely invalid. Worse yet large amounts of investors all acting on the same investment assumptions appears to have the effect of precipitating wealth-destroying imbalances and asset bubbles.

The Tech Stock Market Bubble in Perspective
Of course, as with the real estate market bubble, investor euphoria played a large role in the tech stock market bubble. However I venture that, once again, it was widely accepted investment dogma that allowed people to put on blinders and allocate an ever larger percentage of their portfolios to technology shares. The "historically proved" investment adage that "stocks will always have a positive return over a 10 year period" was often quoted if anyone tried to argue against owning technology shares (I was also called an idiot back then). Now most people also believe that *anyone* could have seen *that* investment bubble coming. So why didn't they? Why shouldn't I assume the same conclusion will be made by investors if the bond market bursts – or (more likely) fizzles? Why read anywhere else a sound explanation for why incredibly knowledgeable investors keep repeating the same "obvious" mistakes with different investment classes?

The Newest Investment "Systems" in Perspective
Rather than throwing out the concept of investment "systems" altogether the "rules" are repeatedly revised to adjust for the most recent market crisis (in retrospect, of course) and new systems are created altogether.

Now many investors are focusing on systems that allocate investments based on company sales, market share, book value, and such (variation of portfolio rebalancing theory that attempts to, using past data, correct for past shortfalls of market cap-based portfolio rebalancing). The system, like others before it (and those that will come in the future), demonstrates that *had* investors allocated their portfolios using that strategy *in the past* they *would have* achieved above-market returns. Because the strategy is based on past data it inevitably is destined for the trash heap… surely to be replaced by yet another fundamentally flawed historically back-tested crackpot strategy.

There is such an allure to the simplicity of having an investment system, investors want to believe they exist so much despite overwhelming evidence to the contrary. Sorry folks, but the *whole concept* of "investment systems" needs to be thrown out the window. There is no baby to save with this bath water. However I doubt the investment community as a whole will *ever* learn this simple lesson, which really is great for those of us who profit from the anomalies and opportunities created by the masses mindlessly following their "systems". Be sure to thank your neighbors, mortgage brokers, and bankers for allowing us to pick up so many quality assets for so ridiculously cheap early in 2009!

<u>Rest In Peace:</u>

- The Nifty Fifty
- The Dogs of The Dow
- The Superbowl Indicator
- Real Estate as the Cornerstone for Financial Advancement
- Stocks as the Cornerstone for Financial Advancement
- "Quant" Funds
- Hedge Funds[5]
- Valueline, Investor's Business Daily, etc
- Technical Analysis
- Momentum Investing
- P/E (Price to Earnings)-based Investing (both based on current P/E variants using longer-term averages)
- Market Cap-based Portfolio Rebalancing

[5] With the current low cost of leverage in today's markets hedge funds may have gained a few years of breathing room but, as I stated in previous newsletters, the assumptions on which they base their large returns with lower variability are, at best, shaky.

- Countless Other Systems from the Past, Present, and Future
- *Coming soon:*
    - Recent "Balanced" Portfolio Variants
    - The 4% Retirement Budgeting "Rule"
    - The Very Notion of What "Safe" or "Conservative" Investing Strategy Should Consider[6]

We Need to Invest Logically, NOT Find a Better System:

Inevitably after each "system" has been proved wrong *everyone* agrees the problem could have been foreseen by *anyone* (of course *had* they simply looked at the data *logically in retrospect*). And thus the "rules" that investors hang their hats on become the nooses from which they hang themselves, as blind overconfidence in systems based on past performance/patterns overcomes rationality. If investment theory is to be considered at all it should serve only as very loose guidelines, investing based upon investment theories alone, without using fundamental analysis and human logic is dangerous. Investment systems can never replace the reason and logic of fundamental analysis.

During the real estate and tech market bubbles market cap-based investment "rebalancing" strategies helped fuel the bubble, but adherents to asset balancing systems came out of those battles with relative mere bruises (at least compared with those who became engulfed by the bubbles). I believe the current market imbalances may prove to be the knock-out punch for many of those still clinging to variations of portfolio rebalancing theory.

Today's Crisis: Abnormally Low Fixed Income Yields and Traditional Asset Allocation Theory

"Investors will likely not know whether the mouse has grabbed for the cheese for several years forward. In the meantime, they are faced with 2.5% yielding bonds… there is no 8% there for pension funds... And the most likely consequence of stimulative government policies… [is] a lower standard of living... a heap of trouble for those expecting more, is what lies ahead."

- Bill Gross, CEO, PIMCO Investments[7] (October, 2010), emphasis mine

I believe that two of today's currently most accepted investment planning dogmas will soon join the lists of investment theories to be shown to be weapons of mass poverty. Traditional portfolio management theory (also known as "portfolio rebalancing") all but dictates retirees must place the majority of their asset in investments in US Government bonds, CDs, and savings accounts. The second dogma is a long-accepted retirement planning "rule of thumb" that suggests retirement spending budgets can be reasonably based on the assumption that withdrawal of 4% of one's portfolio can be done with minimal risk of outliving one's nest egg. In today's market environment these statements, taken together, seem almost certainly incompatible with each other. The math just doesn't work. If recent retirees follow both of these widely held assumptions they are almost certainly going to face financial ruin, assuming they live to their full life expectancy.

There is virtually no way to withdraw 4% of retirement savings while sustaining a portfolio for any significant period of time if retirees adhere to traditional allocation theory where the majority of their portfolio is dedicated to "safe" fixed income that may generate 2.5% pre-tax and pre-inflation returns. Even if bond prices are *not* overvalued the only way for a portfolio to survive a 4% drawdown over the

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[6] I hope to expand on this important concept in a future publication. I believe the financial planning profession is also not properly assessing risk because the currently generally accepted working financial definition of risk does not quantify it in relation to price. This newsletter begins to touch upon that: bonds, real estate, or other investments are not risky per se, but they are risky at certain *prices.*

[7] PIMCO "Investment Outlook," October, 2010 (William Gross), emphasis mine. I have added Gross' quote because he is perhaps the world's most revered bond investor. His affirmation of my independent observations lends substantial credibility to my arguments. Ironically the PIMCO newsletter was released as I was working on this newsletter (after working on it for more than a month). I'm happy that Bill Gross agrees with me but I am also upset that he stole my thunder!

long-term would be for stocks to consistently achieve solid double digit annual gains for at least a couple of decades. It may happen, but I wouldn't want to stake my future on that assumption.

My Proposed Solutions:

- Carefully Selected Individual Stocks, Preferred Shares, Corporate and Municipal Bonds
- Overweighting Certain Sectors and Securities
- Underweighting "High Quality" Fixed Income (CDs, Savings, US Treasuries, Top-rated Corp Bonds)
- Accepting More Uncertainly in Investment Return ("Risk") by Expanding Retirement Budget Elasticity
- Cutting Retiree Return Expectations and Budgets – the *only* option without portfolio changes

We have responded to what appears to be an almost "sure lose" situation of investment in "high quality" fixed income investments by shifting a higher portion of our investments to higher yield (lower quality) bonds, municipal bonds, dividend-paying common stocks, and preferred shares. The rationale for these particular investments is more complex than our simply bucking the crowd and in the interest of not making this publication so large it remains unread and ineffective I will save a more expansive discussion of these investments for a later time. Needless to say I believe the investments we have chosen will provide a substantially better prospect of higher cash yields, inflation protection, and after-tax returns than what I perceive as an almost certain long-term abysmally low to negative real return (after-tax and after-inflation) on "high quality" fixed income investments.

In some accounts, depending on individual client risk tolerance and demographic, we have attempted to mitigate the "risk" of lower exposure to "high quality" fixed income by allocating larger percentages of our portfolios to carefully selected higher quality stocks, preferred shares, and higher yield corporate and tax-free municipal bonds -- even as the fixed income holdings may be of lower quality. For instance, if traditional portfolio allocation theory suggests a 50%/50% allocation to stocks and fixed income (with a large component of US Government Securities) one of my clients may have a 65% allocation to fixed income (with minimal to no US Government bond exposure) and 35% allocation to common stocks (with greater emphasis on high quality dividend paying issues).

Now is the Time to Take Action

Investors must, once again, act *before* it is too late. If investors choose to, once again, not heed the warning signs and still adhere to flawed investment allocation principles I believe they must, at least, adjust their spending assumptions.

I believe we must make our investment allocation decisions assuming that fixed income is currently overvalued[8]. If so then we must make logical investment decisions that account for the fact that investments that were historically regarded as "safe" may in actuality be quite risky. As such the relative risk of a portfolio minimizing the role of "high quality" fixed income should be carefully considered. I see few other alternatives that will more likely lead to a less than messy outcome that I believe will almost certainly lead to *significant* decreased living standards for those who cling to portfolio balancing and other conservative financial planning theories.

Retirees must not only consider taking additional portfolio "risk" than is generally suggested by investment theory based on past performance but they also should be conservative in their retirement budgeting.

This potential asset anomaly is simply too serious to ignore, but almost everyone is. All investors should follow a rational investment plan based on reasoning and logic, not based on simple "rules of thumb" and computer models. For those with accounts under my management I have worked hard to logically

[8] Though an argument can be made that, instead, stocks are dramatically undervalued. But that is yet another perhaps for another time.

choose stocks and fixed income securities which I believe will most likely to yield superior returns at risk levels my investors will find acceptable. As EAM has always done, our managed accounts are centered on analysis and selection of *individual* stock, bond, and other securities. We have particularly focused on the preferred share markets, which may be the feature of a future newsletter.

If I am right then the coming catastrophe will hurt almost everyone, but those most affected will be those who least can afford losses (retirees and near-retirees) and those who have largely avoided the bubbles of times past ("conservative," "balanced," or bond/savings account/CD-centric stoics). By following a "time-tested" strategy those investors may, by default, find themselves at the heart of an asset bubble that may leave them poorer than they ever imagined possible with little hope of recovery.

As always feel free to call or email me if you have any questions or if you simply would like to discuss any aspect of this publication. Thank you for your continued trust and confidence as we, once again, stand virtually alone in our investment planning decisions that are, once again, based simply on sound logic.

Best Regards,

Mark Daniel Elliott
Registered Investment Advisor

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