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**ASSET MANAGEMENT**

*Dynamic Asset Allocation Strategies*

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## 2<sup>nd</sup> Quarter 2004 Newsletter

### ***Even Smart People Can Make Classic Investment Mistakes***

Even successful, intelligent people can make poor decisions when it comes to managing their own wealth. Investors frequently base their investment decisions not on objective analysis, but on their emotional biases. They tend to identify trends or patterns where none exist, or give too much weight to recent or easily obtainable data. They also evaluate gains and losses differently, and while making a smart decision about selecting an advisor, may make poor decisions about how long to stay with that advisor.

Often the difference between success and failure is the investor's ability to recognize their irrational behavior and avoid common mistakes. One of the most common mistakes people make is to chase performance. A portfolio manager may have a good record, but during a quiet period or one of underperformance, the investor may chase the next manager and often this is the wrong move at the wrong time. All managers go through hot and cold periods based on their management style. It is better to pick a good manager who has an investment style or philosophy that fits your own objectives and ideas about investing and stick with him through a complete market cycle. A market cycle can run anywhere from three to five years, based on the average periods for bull and bear markets in most asset classes.

Sometimes irrational behavior from investors is a result of an emotional bias commonly known as "representativeness." This is a tendency to identify patterns or trends where none exist. This also extends to a fallacy that gamblers have where they believe they can predict when a trend will reverse. This is best illustrated where someone flips a coin and it turns up heads five or six times in a row. What are the odds the next coin flip will come up tails? The answer, of course, is you still have a 50/50 chance even though the prior coin flips appear to be a trend.

Financial newsletter writers are always looking for patterns to provide investment direction. An example from the *BTN Research* 2/02/04 issue says, "Wait till 2005 – Since 1935, the S&P 500 has averaged +33.1% in calendar years that end in '5' (e.g., 1935, 1945 ...1985, 1995). Only once in that stretch (1965) was the return less than 30%." However, in the book, *Fooled by Randomness*<sup>\*</sup>, the author makes the point that "We underestimate the share of randomness in anything. We are easily confused between noise and meaning."

Other common mistakes are overestimating one's stock-picking ability and failing to admit having made a mistake. The reluctance to face up to a mistake can lead to an attitude called "regret aversion". This is where selling a losing investment crystallizes the loss and causes regret, where no action allows denial that anything real has occurred. A similar mistake is to hang on to winners for fear of missing out on additional gains. Many investors during the recent bear market watched a significant portion of their net worth get wiped out while waiting for a price level or market value that sadly never came, rather than realizing available gains.

One of the best ways to handle these emotional mistakes is by adequately diversifying holdings. One of the fundamental principals of modern portfolio theory is that investors can manage risk through prudent diversification. Because market risk is still part of a diversified portfolio, it is important to diversify among asset classes, and, maybe even more important, to diversify among management styles. Someone who holds a diversified portfolio of stocks long term does not really diversify away market risk. This is where an actively managed program that recognizes the need to avoid certain asset classes during periods of decline can provide additional value.

<sup>\*</sup> Nassim Nicholas Taleb, *Fooled by Randomness: The Hidden Role of Chances in the Markets and in Life*. New York, Texere, 2001.

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Emotional investing can come into play in many different ways based on motivation, and reasons for holding certain assets. Studies have shown that investors tend to view equal transactions differently depending on whether they are placed in the context of losses or gains. Most people feel the prospect of losing \$1,000 causes greater mental pain than the pleasure of gaining \$1,000. This can cause investors to forego possible strategies that might be perfectly valid for their investment objectives in order to avoid loss.

Investment biases have a large role in determining an investor's portfolio as well. For example, most Europeans have their wealth invested in European companies while we in the United States tend to hold a strong bias towards stocks that are considered to be American companies.

It is also important to be aware of a narrow focus on certain parts of the portfolio that lead to mental accounting. This is the name given to the propensity for people to compartmentalize their money by placing it in different mental buckets. Rather than examining their entire portfolio as a whole, they make decisions in pieces, not recognizing that each part affects the entire portfolio.

One of the most important factors in managing wealth successfully is to remove the emotions from the equations. This is the value added service we provide with our formula driven computerized systems that have shown a high rate of success in the past. We also incorporate multiple asset classes and multiple strategies for every program, and target an investor's risk profile. It is important for investors to understand that not all investment styles or strategies will provide consistent returns over the long run, and that understanding a manager's style and philosophy is as important as reviewing the most recent quarterly performance.

### ***Review of the Second Quarter***

The last three months have seen increasing realization that the fundamental force driving much of the investment environment has been historically low interest rates and a very accommodating Federal Reserve Bank. This landscape is changing rapidly with the first quarter point increase in the fed fund rate ushering in a new era for investors. Lower interest rates provided a tail wind for most asset classes as a result of lowering the cost of borrowing, and making other asset classes more attractive compared to a safe fixed interest return.

Interest rates are still low by historical standards, and rates can creep up over the next few months without any serious damage to the growing economy, and increasing corporate profits. What concerns stock investors at this point is the rate of change in profit growth, and that the economy may be slowing down.

This is also true of bonds, where an increasing interest rate environment makes it difficult for bondholders to net a positive return. While the interest paid on bonds is always positive, the capital value of the bonds held can decline as interest rates go up, so the total return is lower or even negative in some annual periods.

We are now facing the second quarter earning season when companies report their results. In the second half of the year we will continue to have concerns about terrorist threats, higher oil prices, possible stagflation, decline in mortgage refinancing, and a brewing political dog fight.

### ***A Longer View of the Stock Market***

It is intriguing how the market as represented by the S&P 500 declined approximately 49% from its high in the spring of 2000 to the low set in the fall of 2002. From that low to the rally high in the early part of this year, the index gained approximately 49%. This gain recovered about half of the loss from the three-year bear market. The market has been bouncing around in a trading range most of the year, frustrating investors whose patience is wearing thin. Unless we get some kind of an election year rally, it will probably take some of the seasonal patterns that kick in toward November to get the market back up out of the doldrums.

There are many studies that an election year is normally positive in a four-year market cycle due to politicians who make promises for improvement, and a culmination of four years of an attempt to put the economy right so that voters will re-elect the incumbent. The problem with most of these studies is that they are not statistically significant, because there are not enough years in the study to make the studies relevant. With presidential elections occurring every four years, there are only 25 events in a 100-year period, and that is not enough data to draw any real conclusions. Unfortunately, this is one of the many topics that newsletter writers and commentators like to expound upon to fill space, but they have no real significance for predicting the future. One example of this is provided by the Leuthold Group, which indicates that, going back to the end of WWII, the median return of the S&P 500 in the 12 months following an initial rate hike by the fed has been +9.9%. There are not enough data points in that time period to draw any kind of valid conclusion about what may happen this time. The good news is that corporate profits, the employment rate, and other measures of economic expansion are better than they have been for the last few years, and may lead to gains in the market. The problem is there are so many factors including anticipation of future profits and inflation and also surprising political and economic events that can affect the outcome of these asset classes. This is one of the reasons that our models are designed to react quickly to changes, and we feel that active management is an important priority for long-term success.