WEDGE WATCH

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To Err Is Human

"Day-to-day fluctuations in the profits of existing investments, which are obviously of an ephemeral and non-significant character, tend to have an altogether excessive, and even an absurd, influence on the market."
– John Maynard Keynes, English economist (1883-1946)

"Of all the ways of defining man, the worst is the one that makes him out to be a rational animal."
– Anatole France, French novelist and storyteller (1844-1924)

Fourth Quarter 2004 Financial Statistics

DJIA: 10783.01

S&P 500: 1211.92

90-Day T-Bill: 2.21%

30-Yr. T-Bond: 4.83%

Early last fall, we had the opportunity to attend an investor conference in Boston that focused on the field of *behavioral finance* (the study of the role of emotion in financial decision making). As devout contrarians, we have long been enamored with the interplay between psychology and individual stock prices. One of our first introductions to this fascinating field came back in the early 1980's with the publication of David Dreman's excellent *Contrarian Investment Strategies.* Dreman's basic premise was that investors tend to overreact to both good and bad news, creating opportunities for the disciplined contrarian value manager to profit from the powerfully persistent force of *mean reversion.* In the years since the book's publication, numerous well-researched academic studies, measuring results over extended time frames, have touted the value of such a contrarian approach (in part by showing that ***value*** has trumped ***growth*** over time). Thankfully, however, the psychological dynamics which drive the outperformance of this contrarian style have yet to be competed away in the marketplace. Unlike a number of other investment-related anomalies, this one is rooted firmly in the makeup of human psychology; hence its historic persistence.

In recent years, the stature of the *behavioral finance* field within the investment community has begun to improve. This was evidenced by the awarding of the 2002 Nobel Prize in economics to Princeton psychologist Daniel Kahneman for his collaborative work in the field with the late Amos Tversky. However, it remains, for the most part, a somewhat misunderstood and underappreciated niche. This point was driven home to us anecdotally during our attendance at the just noted conference (held on the campus of *Harvard University*). During the first day's introduction, Richard Zeckhauser, a long-time economics professor at the school and host of the program, light-heartedly referenced the oddity that the conference was being held at the *John F. Kennedy School of Government,* instead of the highly-ranked *Harvard Business School,* the more logical venue for such an event. The reason: the business school's esteemed but tradition-bound faculty remained devoted to the *efficient market theory* long advocated by academic purists and, as a result, had turned down the opportunity to host the program (fearing it would add legitimacy to a competing view). Given the sizable revenue (i.e., fees and tuition) generated by this annual program however, we have a feeling that the business school's decision to pass on the event was not, like their view of the market, a highly efficient one.

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Human

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Although the field of *behavioral finance* remained relatively obscure for many years, the basic tenets of its teachings can be traced back to the early stages of the twentieth century. In fact, throughout the history of modern finance, the amassing of many great fortunes (both in stocks and real estate) can be directly tied to the savvy exploitation of base human instincts (i.e., fear and greed). John Maynard Keynes, arguably the most famous and influential economist of the twentieth century, prominently highlighted *behavioral finance* in his seminal 1936 text on economic theory, *The General Theory of Employment, Interest and Money.* Keynes, like the great investors of history, understood that human nature was a constant and that investors were naturally inclined to overreact to both good and bad news (regarding individual stocks). In fact, based largely on the disciplined exploitation of this nuance, he built a substantial personal fortune while also successfully presiding over an endowment portfolio for *Kings College* (Cambridge, England) from 1928 to 1945. During his tenure as manager of the fund, the portfolio compounded at a remarkable per annum rate of 13.2%, despite a massive hit from the Crash of 1929, versus the general market in the U.K. which declined by an average of 0.5% per annum. These returns led to a *nine-fold* increase in the value of the endowment's assets, versus what would have been an actual decline in value had the portfolio been invested in the broad market.

A careful study of Keynes' writings reveals his intuitive feel for the behavioral tendencies exhibited by investors (although the term *behavioral finance* would not be coined for many decades thereafter). In Chapter 12 of his *General Theory,* he scoffed at the typical professional investor (of his time) who tended to consciously or subconsciously embrace the more myopic short-term view, relating to individual stocks, as opposed to the much more relevant longer-term (compounding) opportunity. These individuals, according to Keynes, *"were largely concerned, not with making superior long-term forecasts of the probable yield of an investment over its whole life, but with foreseeing changes in the conventional basis of valuation a short time ahead of the general public.* ***They are concerned, not with what an investment is really worth to a man who buys it 'for keeps,' but with what the market will value it at, under the influence of mass psychology,*** *three months or a year hence."* This misdirected focus was, in his mind, a major obstacle to the successful compounding of portfolio returns over a long-term horizon.

In addition to Keynes' obvious disregard for the excessively myopic, speculative orientation of most investors, he also bemoaned their central tendency to over and underreact (to both good news and bad): *"A conventional valuation which is established as the outcome of the mass psychology of a large number of ignorant individuals is liable to change violently as the result of a sudden fluctuation of opinion due to factors which do not really make much difference to the prospective yield (or return of the stock over the long term)."* In other words, investors are prone to the knee-jerk emotional response rather than the measured contemplative approach so imperative to achieving long-term investment success. Like Keynes, we have found that it is the very conscious and intentional effort to fight this natural tendency that can, in many cases, make the key difference between superior and mediocre results over time. In other words, **comfort and expected return tend to be inversely related.**

"People who have no weaknesses are terrible; there is no way of taking advantage of them."
– Anatole France, from *The Crime of Slyvestre Bonnard*

A brief summation of Keynes' stock selection and portfolio management philosophy highlights his core emphasis on **discounted valuation and a longer-term orientation**, two *common* and *primary* ingredients employed by successful value investors. His basic approach, which sought to counter the natural behavioral tendencies and biases of most investors, remains as sound today as ever:

a) A careful selection of a few investments having regard to their cheapness in relation to their probable and potential intrinsic value, over a period of years ahead, and in relation to alternative investments at the time;

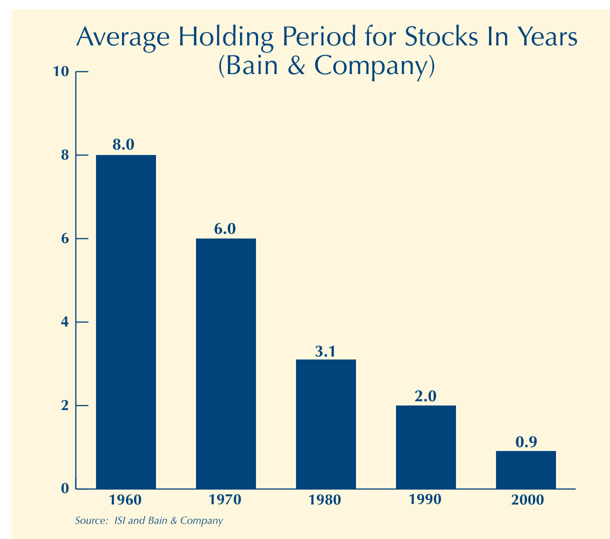
b) A steadfast holding of these fairly large units through thick and thin, perhaps for several years, until either they have fulfilled their promise or it is evident that the purchases were a mistake;

c) A balanced investment position encompassing a variety of risks in spite of individual holdings being large, and, if possible, opposed risks likely to move in opposite directions when there are general fluctuations.

Many decades have passed since Keynes wrote *The General Theory;* however, the psychological underpinnings that drove stock price movements during his era remain fully intact today. In fact, there is a relatively strong case to be made that the bull markets of the 1980's and 1990's have actually exacerbated the market's emotional swings. At the same time, competitive intensity in our business has increased dramatically via explosive growth in the number of mutual funds and hedge funds aggressively vying for investor dollars. The net result is that investor time horizons have compressed dramatically as these performance-stressed fund managers have placed an ever higher premium on short-term performance results. Were Keynes alive today, this trend surely would not surprise him.

Chart 1 provides a graphic display of how this phenomenon has played out. It illustrates the dramatic and ongoing compression in average institutional holding periods (for stocks) that has evolved over the past forty years. In an allusion to this increasingly ubiquitous trend, Peter Bernstein, noted economist and one of today's most insightful observers of the global investment landscape, stated the following during a 2003 keynote address to the CFA Institute: ***"Professional money managers are reluctant to take strong contrarian positions*** *for fear that they will lose business (due to the open-end nature of the business). As a result, they are tied much more tightly to short-term (trend following) strategies than they might like because they cannot persuade their clients to wait for the period of time that is required for a longer term strategy to work out. Contrarian strategies, therefore, tend to be perceived as very risky by money managers, not only in terms of returns over the short run but also, more importantly, in terms of fickle clients and shareholders.* ***The fear of being wrong and alone is a very powerful one!"***

Chart 1



As veterans of the investing wars, we acknowledge the formidable psychological obstacles to effectively implementing and carrying out a disciplined contrarian value strategy; however, through years of experience and via extensive quantitative modeling, we believe that we, and others, have demonstrated the compelling merit of such an approach. With holding periods for common stocks continuing to compress, we see great opportunity to leverage our fundamental analytic work by taking a longer-term view. Our time horizons tend to be more distant than those of the average money manager and, as a result, the always prevalent emotionally-driven tendencies of investors stand ready to trigger uncommon opportunities. For us, as it was for Keynes, the key is to maintain the discipline of such a *mean reversion* strategy and, although the payoff can at times be slow to evolve, we have found that it is well worth the wait. As Jesse Livermore, legendary early twentieth century stock trader and keen observer of market psychology once said: ***"The big money is made by the sitting, not the thinking. Once a position is taken, the hardest thing to do is to be patient and wait for the move to play out."***

As always, we appreciate your business and continued support. Have a happy, healthy and prosperous New Year!

The Stock Market

Clear Sailing Ahead?

As is usually the case, it's anyone's guess as to whether the post-election relief rally in stocks is a precursor to even better days ahead (in 2005). However, what we do know is that the S&P 500 is up over 10% since the early August 2004 low and up over 50% from the early October 2002 cycle low for stocks. Robust returns indeed, especially given the relatively short durations measured. Although we hesitate to predict broad market returns, some caution may be warranted, at least in the short-term, given how far we've come in just two short years. For those who watch sentiment indicators closely, two such prominent signals appear to be flashing caution. As of this writing (12/17/04), the *Investors Intelligence* survey shows 62.1 percent of investment newsletter writers were optimistic about stocks in the prior week. This is the highest reading since January 1987, a point in time just months ahead of the notorious **"Black Monday"** market debacle which sent stocks down 20% on October 19, 1987. In addition, the much watched VIX index, which measures levels of optimism and pessimism on the Chicago Board Options Exchange, just hit its lowest level since January 1996, a sign of distinct confidence amongst options traders regarding the outlook for stocks.

Despite these potential red flags, however, fundamentals remain relatively robust, although a slowing in earnings growth is likely given increasingly difficult comparisons going forward. Two key swing factors that could impact equity returns in the New Year are the price of oil, which has experienced a meaningful reversal off its recent highs, and the overall interest rate/inflationary backdrop. Any significant surprises on either front would likely have a material impact on stock prices, especially if inflation were to surprise on the upside. In terms of capitalization opportunities within the realm of value stocks, it would appear that large-cap stocks now offer better relative value than small-cap and mid-cap stocks, with both small-cap and mid-cap having led once again in 2004, posting very strong double-digit gains.

As we continue to direct our research efforts toward compelling risk/reward opportunities, we currently see fewer attractive names in some of the more cyclical groups, such as capital goods and basic materials, where a sizable number of stocks have doubled over the past two years. The technology sector, on the other hand, appears to offer several interesting opportunities given the overall stock price weakness there in 2004. In terms of the more defensive sectors, select health care stocks, such as pharmaceuticals, appear to be well oversold while electric utilities, which rallied strongly with bonds during the back half of last year, appear quite extended given their low growth outlook and regulated returns.

Index	12/31/04 Price	4th Quarter Price Change*	Year-to-Date Price Change*
Dow Jones Industrials	10783.01	7.0%	3.1%
S&P 500	1211.92	8.7	9.0
Value Line Composite	404.43	12.6	11.5
American Exchange Comp.	1434.34	12.8	22.2
NASDAQ Composite	2175.44	14.7	8.6

**Does not include dividend income.*

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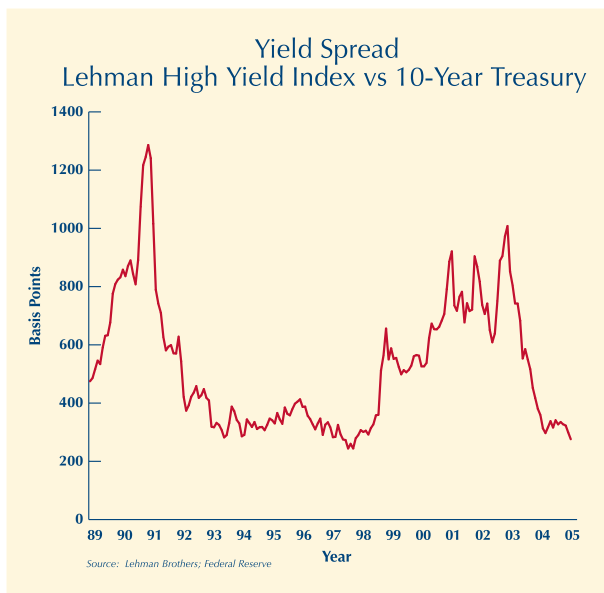
Fixed Income

The Low Down on High Yield

The high yield or "junk" bond market has certainly performed well in recent years. Similar to the investment grade sector, yield spreads versus U.S. Treasurys **(Chart 2)** have narrowed tremendously since the end of 2002. After being battered for several years by rising defaults, high yield investors were treated to outsized equity-like returns during 2003 and to a lesser extent in 2004. **In fact, spreads are rapidly approaching the relatively narrow levels that existed during certain periods in the 1990s.**

Chart 2



What drove the improvement in the high yield market? Certainly, the ample doses of liquidity provided by the Federal Reserve in the wake of the 2000 bursting of the stock market bubble and the 2001 recession/terrorist attacks helped set the stage. The ensuing economic recovery buttressed the confidence of investors that junk-rated companies would be able to service their debt. Also, the U.S. high yield default rate, as measured by Moody's, finally peaked at 11.5% in early 2002 and subsequently began a fairly steep descent. The defaults, while painful for those involved, were a necessary condition for the recovery in the high yield market because they cleansed the system of the weakest credits. Another factor that contributed to the strong performance was simply that yield-starved investors, faced with rates on Treasurys at multi-decade lows, flocked to the junk market in search of higher returns.

Why is it relevant for us to focus on the high yield market? As investment grade managers, it is imperative that we be proactively aware of developments in other sectors that could impact fixed income markets in which we actively participate. Therefore, it is in the best interests of our clients that we stay abreast of the ever-changing landscape across fixed income. In that regard, several other interesting developments, beyond the high yield spread narrowing just discussed, have also evolved. For example, the strong demand backdrop for high yield offerings has provided a window of opportunity for increasingly riskier (lower-rated) companies to access the bond market. As shown in **Chart 3**, the percent issuance from B-rated companies has risen while the percent issuance from stronger Ba-rated entities has declined. In fact, the net issuance of very low quality Caa-rated debt has exceeded that of Ba-rated debt thus far in 2004. Why is this important? Historically, companies that issue debt in the B-rated category and below have substantially higher default rates than those in the Ba-rated category. Further, history suggests that defaults generally begin to increase two to three years after issuance. **As a result, this outsized issuance from the B-rated category virtually ensures that defaults will begin to increase at some point during the next few years. When that eventually occurs, investors will likely begin demanding a higher risk premium, via wider spreads, to compensate for the increased risk of default.**

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Chart 3

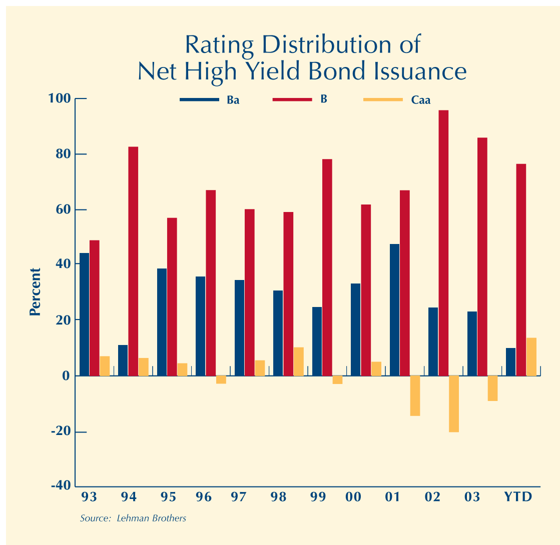
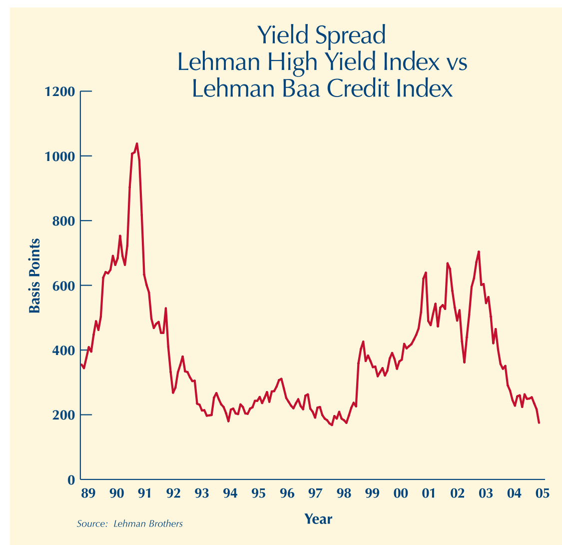


Chart 4



Our final observation helps further explain why we believe an analysis of the high yield market is relevant at this time. **Chart 4** shows the spread between the Lehman High Yield Index and the Lehman Baa Index. Note that this spread has compressed dramatically and is also near the tightest levels witnessed during the decade of 1990s. **If high yield defaults do indeed pick up over the next few years, as we anticipate, a spillover effect may evolve causing spreads to widen in the lower-rated portion of the investment grade arena.** We must emphasize, however, that we do not anticipate a severe spread reversal developing in the near term. Indeed, this relatively narrow spread environment could be with us for some time given the numerous positive underpinnings currently bolstering both the economy and the capital markets. We are merely remaining mindful that spread levels in both the high yield and investment grade markets appear to have factored in a large majority of these positive influences. **As a result, we maintain our view as expressed last quarter: valuations are full and risks are rising, leading us to remain conservatively postured.**

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