January 18, 2010

Here is our newsletter for the 4th Quarter of 2009.

2009 Markets Review
All the equity markets staged a strong rebound after the lows reached in March. The S&P 500 index gained 26.5% for the year. The overseas markets did even better with gains of 37% and 76% for the developed and emerging markets respectively.

Our Portfolios
All of our portfolios outperformed their benchmarks for the year despite trailing for the last six months. Our Equity-Tilted composite gained 23.6% vs. 18.8% for the benchmark. Our Balanced composite gained 20.5% vs. 15.2% for the benchmark. Just as importantly, we made those returns with less than benchmark risk by roughly 25%.

By far the biggest factor in our outperformance was our holding in high-yield bonds. The fund held in the portfolio was our biggest single holding at about 18% and returned 49% for the year.

Outlook for 2010
A consensus among economists and fund managers we respect points to a long and slow recovery after the current recession is over, and it may not be over until sometime in 2010. This subpar recovery is rooted in the deleveraging process that has just started. What we have seen so far is mostly a shift in the debt load from the private to the public sector, as governments around the world are trying to pick up the slack in their economies now and hoping they can pay back the debt in the future as they withdraw the unprecedented stimulus.

While the economy registered a positive GDP in the 3rd quarter, and will likely register another positive reading in the 4th quarter, the economy may still be in recession. The National Bureau of Economic Research (NBER) sets the official dates for the beginning and end of recessions. It dated the start of the current recession in September of 2007, and did so about six months after the start of the recession. They base their determination primarily on four economic measures. Of the two measures based on production, one is showing a respectable rise and the other is showing a subpar recovery. The 3rd indicator, personal income is flat. The 4th measure, employment is still going down. In total these indicators point to an economy that could still be in recession although we have seen positive GDP over the last six months. There have been jobless recoveries, as in the recovery from the 2001 recession, but never a ”jobloss” recovery.

Overseas, the European recovery looks to be even weaker than in the U.S. Asia (except Japan) and the rest of the emerging markets should provide for most of the worldwide growth in the economy in the near future.

With the market rise of last year, current valuations such as P/E ratios for the domestic and foreign stock markets are on the high side. Stock markets and thus P/E's could always go higher and stay high for some time, but this level of P/E has generally has not been a good long-term entry point into the stock market.

So where does all of this leave us? We are currently doing what has worked the last two years, which is to have lower than benchmark risk in our portfolios. We continue to underweight equities and overweight bonds, primarily corporate and overseas bonds where we see better value. We also continue to avoid REITs and hold a small allocation to our commodity index fund.

Rats and Pigeons: Born to be Better Investors than Humans?

It has been over a year since I read "Your Money & Your Brain: How the New Science of Neuroeconomics Can Help Make You Rich". This new science, using advanced imaging of the brain has actually identified how and where we process our thoughts as investors. The author, Jason Zweig has been a financial journalist since 1987 and is currently writing the personal finance column in the Wall Street Journal. I had the pleasure of meeting him 2007 before his book went to press when he presented at a NAPFA advisors conference.

After a few opening remarks he quickly pulled a rubber chicken out from behind the podium and threw it at the audience. Everyone in the audience at least flinched, including me, while several others gasped with fear. His point was to illustrate how we all use our "reflexive" part of our brain. The reflexive part of our brain is the largest and has been developed over many millions of years. When prehistoric man saw a lion jump out of the bush, his immediately reaction was to run his ass off. He did not contemplate his options, do some research on the internet or consult an advisor about what to do. His reflexive part of his brain developed in response to the mortal dangers that occurred every day.

A second part of our brains can be described as the "reflective" or analytical part, which has been developed more recently in modern times. Researchers have identified how the reflexive part of our brain often overpowers the reflective part when making investment decisions. One of their findings identified how financial losses are processed in the same area of the brain that responds to mortal danger. I suppose this in one of the reasons why early last year many investors were scared out of the stock market as the market approached 12 year lows.

Another part of the brain has been seen to light up when we make a prediction and it comes true. This part of the brain also responds to sexual pleasure. Unfortunately humans can be pretty dysfunctional when it comes to making predictions. The book describes an experiment where rats and pigeons were better predictors than humans. In the experiment researches flash two lights, one green and one red, onto a screen. Four out of five times, it's the green light that flashes; the other 20% of the time, the red light comes on. But the exact sequence is kept random. In guessing which light will flash next, the best strategy is simply to predict

green every time, since you stand an 80% chance of being right. And that's what rats or pigeons generally do when the experiments reward them with a crumb of food for correctly guessing what color the next flash of light will be.

Humans, however, tend to flunk this kind of experiment. Instead of just picking green all the time and locking in an 80% chance of being right, people will typically pick green four out of five times, quickly getting caught up in the game of trying to call when the next red flash will come up. On average, this misguided confidence leads people to pick the next flash accurately on only 68% of their tries. Stranger still, humans will persist in this behavior even when the researchers tell them explicitly that the flashing of the lights is random. And, while rodents and birds usually learn quite quickly how to maximize their score, people often perform worse the longer they try to figure it out. The more time they spend working at it, the more convinced many people become that they have finally discovered the trick to predicting the "pattern" of these purely random flashes.

Humans often see what they think are long term trends, but base their analysis on short-term data. An article in the December 31 issue of the Wall Street Journal shows how this hurts most investors. It stated that the CGM Focus fund was the top performing mutual fund, by far, over the past ten years, generating an annualized return of more than 18% a year since January 1, 2000 on a time-weighted basis. However, over the same ten year period the average investor in this top-performing fund lost an average of 11% a year. How is it possible for investors to lose their shirts in a fund that posted outsized returns?

Morningstar, whose data is used by most financial advisors, including myself, calculated what is called the "dollar-weighted" return of the CGM Focus fund, which gives a picture of what investors in the fund actually experienced. If you had bought and held the fund throughout the 2000s, you would indeed have received returns of 18% a year. But the fund was so up and down those investors were alternately panicked and selling out or optimistic and crowding back in. The article says the most dramatic example came after the fund was up 80% in 2007. Investors flocked in, putting $2.6 billion into the CGM portfolio--just in time to catch its equally-dramatic 48% drop through the end of 2008.

There have been many credible studies showing that the average investor underperforms the market, some by as many as 6% per year, and this illustrates exactly how it happens. Right after an investment generates strong returns, people tend to jump on the bandwagon after they notice the strong performance over a short period of time. When an investment is struggling, people tend sell out and miss out on its recovery. Ahhh, if we could only bring out the bird-brain in all of us!

Thank you for your continued interest and let me know if I can be of any service.

Sincerely,

Stan Johnson, CFP(R)
Comprehensive Financial, Inc.
Registered Investment Advisor