Registered Investment Advisor Firm

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Cosmic Similarities?

"Never argue with stupid people. They will drag you down to their level and then beat you with experience" – Mark Twain.

No one knows what's going to happen in the future, especially when it comes to the financial markets. That's why there will always be topics up for debate. There will be circumstances that seem to defy logic and you might swear history is repeating itself with uncanny accuracy and an almost cosmic attunement.

This is because we as humans are conditioned to search for similarities, not differences.

Case in point, Abraham Lincoln and John F Kennedy were remarkably different people in thousands of ways. But let's look at the similarities between these two men and their circumstances in life:

Lincoln was elected to Congress in 1846, Kennedy was elected in 1946. Both went on to become Presidents of the US, elected 100 years apart. Both were shot in the head and killed by assassins who were commonly known by three names containing 15 letters – John Wilkes Booth and Lee Harvey Oswald. Neither of their assassins ever made it to trial.

Lincoln had a secretary named Kennedy while Kennedy had a secretary named Lincoln. They were both killed on a Friday while sitting next to their wives.

Lincoln was killed while seated in the Ford Theater, and Kennedy while seated in a Lincoln manufactured by Ford.

Both would be succeeded by a man named Johnson: Lincoln by Andrew Johnson who was born in 1808 and Kennedy by Lyndon Johnson who was born in 1908, each Johnson having 13 letters in their names.

So what does this have to do with investing and your 401(k)? My answer is plenty, because there are some people in the financial industry that look at both sides of an argument and make their decisions using unrealistic probabilities, many times based on similarities and their *confirmation bias*.

The problem is you won't hear much of this "level-headed reasoning" critiqued because it gets drowned out by the overconfident prognosticators that make their forecasts with complete certainty.

In the financial services business, we affectionately refer to them as "perma-bears" and "perma-bulls," and they don't really like to look at both sides of an argument because it doesn't fit their world view. They have their viewpoints and nothing you say will change them.

A good way to explain this is to look at some examples of the "perma-arguments."

Bull Arguments:

- Cash remains on the sidelines.
- Forward looking P/E ratios are low.
- Sustained low interest rates.
- Stocks are down, so buy the dip.
- We're cautiously optimistic.
- It's a second half story.
- Sure the market is a bit stretched here but the companies we own are extremely undervalued.

Bear Arguments:

- Anything from the latest John Hussman weekly commentary.
- CAPE (Cyclically Adjusted Price-to-Earnings) ratios are above average.
- Marc Faber's latest *Boom, Gloom & Doom* crash call.
- Just about anything from *Zero Hedge*?
- Calls that the financial system is built on trust and once that trust is gone it's over.
- Our crippling government debt obligations.
- Look at the long-term stock chart on an inflation or gold-adjusted basis?
- Look at how much gold the Chinese government is buying.
- Have you seen the chart that looks exactly like 1929 or 1987?
- The market always crashes eventually.
- Hyperinflation is coming.

In past issues, I've addressed *confirmation bias*, what it is and how it effects not only your investing decisions, but just about everything else in your life as well.

Confirmation Bias Arguments:

- *Oil prices are up.*
  Bulls: Proves the economy is doing better.
  Bears: Consumers have less discretionary spending as a result.
- *Oil prices are down.*
  Bulls: Consumers get a boost in their pocketbook from the price of gas dropping.
  Bears: This proves economy is doing worse.

- *Economic growth is stagnating.*
  Bulls: Expectations are too low.
  Bears: There's a huge disconnect between Wall Street and Main Street.
- *Economic growth is picking up.*
  Bulls: Company profits should increase.
  Bears: The stock market is not the economy.
- *Market sentiment is bullish.*
  Bulls: Follow the trend, a rising tide raises all boats.
  Bears: The "crowd" is always wrong.
- *Market sentiment is bearish.*
  Bulls: The "mom and pop" investors are always wrong.
  Bears: Stock up on canned food and gold, the system is finally coming down.

There was an interesting 2009 study that further illustrates elements of *conformation bias*, though the study addressed "the evolution of superstitious and superstition-like behavior and the results of getting it wrong. The study was conducted by Harvard University's Kevin R Foster and the University of Helsinki biologist Hanna Kokko.[1]

In their study, they used evolutionary modeling to demonstrate the costs associated to genuine vs. false patterns. I found their findings both fascinating and intuitive, in that when the cost of believing a false pattern is real, natural selection will favor the false pattern over the genuine pattern.

[1] You can access the study here: http://rspb.royalsocietypublishing.org/content/276/1654/31.abstract

For example – believing that the familiar rustle of tall grass is a predator when it's only the wind does not cost much, but believing the reverse - that a dangerous predator is only the wind, may cost an animal its life.

Everyday market pundits tell us why the markets did what they did. We want to believe, and can't accept randomness because we are looking for similarities.

As always, remember that the majority of the arguments you hear (mine included) have a strong case of *confirmation bias*. If you're a DIY (do it yourself) investor, be sure to do your own homework when making any investment-related decisions. Don't blindly follow anyone's advice just because their argument sounds intelligent and lines up with your current investment posture.

The relationship of risk and return

Sometimes I receive requests to invest a client's assets, with the caveat that they don't want to "lose any money" but want to make "high returns." Not all risk is created equal. Smart risk is characterized by its ability to yield greater returns on your investment.

Smart risk is compensated risk: the type that helps your assets grow to their greatest potential, while remaining congruent with your risk aversion.

An appropriate amount of smart risk is necessary within a healthy, well-diversified portfolio. However, everyone's risk tolerance is a highly personalized matter. There is no one-size-fits-all solution to the question of how much risk is right for you.

The need to diversify

Independent academic research shows that the best way to make and keep your wealth is through a diversified portfolio. A properly diversified portfolio takes into account not just diversification across asset classes, but within them.

The Irreplaceable Value of Independent Advice

Independent fiduciaries like Davis Investment Group (DIG) are legally required to act in the best interests of their clients. As a completely independent firm, DIG is beholden to no one but our clients. There are no self-branded DIG mutual funds. We never accept commissions nor any other incentive.

When an investment is placed in your portfolio, it is for one reason and one reason only: because it is the best possible investment opportunity selected from each country, currency, and commodity across the globe.

At DIG, we know that the single most important investment we make is our members' trust. We take nothing more seriously than our fiduciary responsibility to uphold the best interests of our clients. No conflicts of interest, no off-the-shelf solutions, no slick marketing, just independent, data-driven investment advice.

Davis Investment Group

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If have questions or would like further information on this month's topics or any other financial or investment related subjects, including Social Security claiming strategies, please contact me directly at (925) 360-6819 or through my email address at: Bud@DavisInvestmentGroup.biz