TW Advisors

December 2010

"Tis the Season for Trimming??

The first step in developing a successful investment strategy is to have a model that correctly understands the stock market. For instance we believe the evidence clearly shows that the stock market does a good job of pricing stocks **most of the time** with occasional bouts of irrationality. It is these times of irrational pricing that give us an opportunity to add value, but it also requires patience as by their very nature these opportunities are not that frequent.

This belief is consistent with recent research (the most readable example is James Surowiecki's *The Wisdom of* Crowds) that builds a compelling case that groups make better decisions than individuals, including experts, in a wide range of fields and applications. Collective wisdom is evident at two on-line markets: Intrade, a prediction market noted for accurate election results, and the Hollywood Stock Exchange, where visitors wager on box-office returns and the Oscars. The track record of both these prediction markets has been remarkable, especially compared to individual experts.

If crowds are wise, why does the stock market sometimes get it spectacularly wrong? One explanation based on collective wisdom research is that crowds are only wise when they are **diverse and independent.** Usually these two conditions are met in the stock market, but sometimes they are absent, allowing prices to wander far from reasonable value.

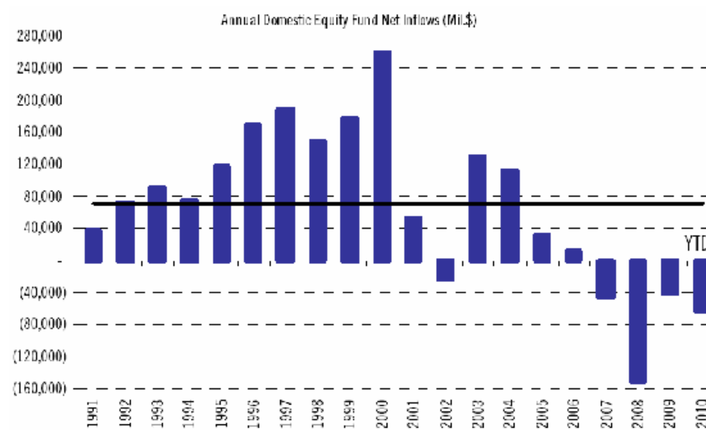
We used this model and methodology to avoid most of the sub-prime mortgage and broader housing debacle. In March 2007 we wrote the following on the blog on our website:

> *For any investor worried about managing risk there is a must-read March 27th article in the Wall Street Journal by Dennis K. Berman.*
> *This article highlights the frenzy going on in the overheated debt markets. The comment that really caught our eye was from a Princeton economist who studies bubbles named Markus K. Brunnermeier. Referring to the banks that make loans and sells them to institutional investors he said, "You try to forecast when the others are getting out. You don't focus on the fundamentals. You focus on the other players." In other words, "the greater fool theory" is alive and well in the bond market. When market players stop focusing on fundamentals and become dependent on the actions of others, prices are no longer tied to value and can become inflated.*
> *At some point these fools will stop buying debt with modest returns and high risk. When this occurs asset markets will likely readjust to lower valuation levels.*

Recently we have done some selling in our portfolios as the impressive fall rally pushed some of our holdings to full value. The expected year end rally seems to have been "pulled forward" into the September/October period and several other developments, such as increased volatility, high investor optimism, European debt worries, and tightening credit in China, have added to our discomfort.

It also appears that markets are once again becoming highly correlated (they are acting alike) which is a key ingredient in turning a wise crowd mad. We have also been bothered that individual investors continue to withdraw money from our stock market, normally a buying signal (see chart below).If the market is mostly dominated by trader-types, as opposed to "investors" prices could become distorted and risk could be elevated. A November 20th article in the *Wall Street Journal* wrote about the high correlation between the stock market and commodities this year:

> *Algorithmic trading programs, or "algos," automatically buy and sell a wide variety of assets based on mathematical models. An algo doesn't know or care why two assets are moving together; it merely is programmed to recognize that they are doing so. As soon as a computer places bets that such a linkage in prices will persist, other traders—computers and humans alike—tend to take note and follow suit. That can be true, Mr. Simons says, whether or not a correlation is driven by fundamental economic factors. "We've gotten to the Frankenstein point where algos are self-programming, and they evolve to chase these relationships," Mr. Simons says. "That's created a sheer wall of money that is forcing other people's behavior into the same pattern."*



Both of these observations suggest the stock market is losing its diversity and independence. Seems like a good time to take some risk off the table, raise a little cash, and emphasize the bargain Blue Chip stocks that have largely ignored the recent rally.

Wishing you a Happy and Healthy Holiday

Steve Wenstrup and Jim Tillar, CFA

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