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Be a Contrarian Investor

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Humans, generally, like to cooperate. It's a key ingredient for our societies to work. We send our kids to schools that teach mostly the same things, we try to speak the same language, we agree to drive our cars according to pre-agreed rules, on and on and on. The opposite of this harmony is anarchy, and few among us desire that.

After centuries of cooperating, forensic psychologists assert, most of us feel uncomfortable if we start to run against the grain. In large part this keeps us 'in check' and we don't have to have laws about every single human endeavor. It is the subtle grease that makes our lives easier than they would otherwise be.

Turning to the subject of investing, however, this tendency helps explain how societies get into trouble financially. Driven by the desire to cooperate people yearn to fit in with the 'investment' crowd. So and so mentions an investment they made that is performing well. So two of those who listened at that cocktail party buy that investment and, based on the inflow of their new buying, the price goes higher. Then they tell others of their good fortune who become buyers too.

If this process continues long enough the outcome is predictable. The investment will go from being priced low, to over-priced. The early buyers will make money, the later buyers will lose. It's the old adage; 'What the wise man does in the beginning, the fool does at the end'.

Value Investing attempts to give a logical and mathematical framework to prevent investors from being fools. Ben Graham, teacher and mentor to Warren Buffett, appropriately named his famous book 'The Intelligent Investor'. In it he teaches that prices move up as the supply of new investors increases, and preaches that you need to analyze investments with common sense and a calculator.

It is here that investors need to recognize that 'running with the crowd' can be disastrous. Every investor understands the idea to 'buy low and sell high'. But to buy low requires that you do something different than the majority. I observe two reasons people don't. Either they don't understand this relationship, that like a teeter totter, the weight of the crowd will drive their profits down or, they are simply unable to operate independently of their friends and neighbors.

What does this mean in 2013 ? We observe a lot of crowd behavior as the Fed pushes interest rates to record lows. Investors are frustrated and looking for better yields. Over the last couple of years bond prices have risen as investors piled in with money from CD's. The crowd-following investors see these returns and want them. The longer rates stay low, the more likely it is that stocks and bond prices will move into bubble territory.

Conclusion. If you find yourself running with the investment-crowd, slow down and take a sober look at the big picture. Prices tend to run to extremes: they are too low when the crowd moves away, and become too high as the crowd piles in. The reverse of this is to be a Contrarian: sell when others are buying and vice versa.

I plan to continue to drive on the right side of the road and cooperate with most of our social norms. But in investing I'll be a Contrarian. It's the most predictable way to use the securities markets to your advantage.

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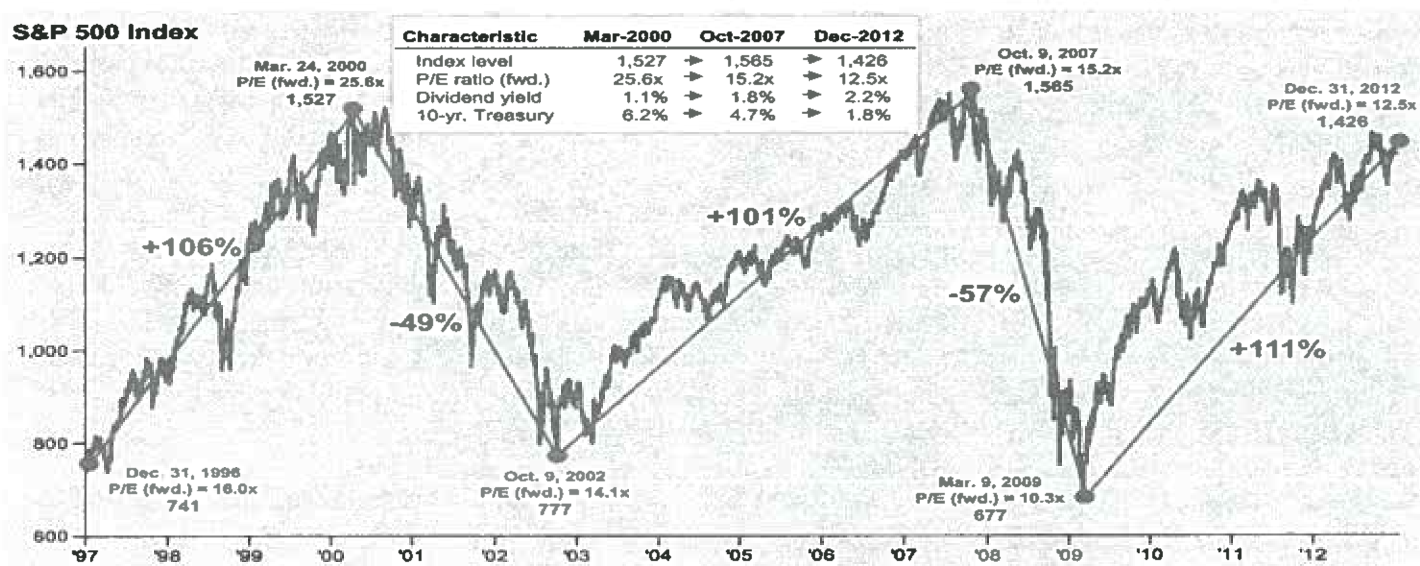
12 Years In.....

When I was a kid, I recall many futurists begin their predictions of our rosy future with the phrase "In the year 2000", followed by a description of the marvels that awaited us. That distant date held such promise to the youngsters of the post-WW2 Baby Boom. In that era, US technological advances had us thinking we'd all drive flying cars by now. Even if tech innovation hasn't quite lived up to the hype, the computing power resulting from Moore's Law has produced some amazing results that have most certainly improved our standard of living.



While our technological lives have experienced a steady, upward advance, the same can't be said about our financial lives. We fail miserably and repeatedly at economics. Maybe that's why it's called The Dismal Science. This Time Is Different: Eight Centuries of Financial Folly, by Reinhart and Rogoff, is the definitive book on this subject.

The above chart shows the change in the S&P 500 Index over the past 16 years, more than half of my 30 year career as an investment advisor. What a wild ride it's been for those who believed that stocks were the place to be "for the long run". After doubling three times and crashing by half twice, any index investor finds themselves 12 years into the new millennium with a severe case of whiplash and nothing to show for it. The tech-laden NASDAQ is still almost -40% below its all-time high.

Of the three market advances shown since '96, only the first can be said to have occurred on business fundamentals, largely driven by the mass adoption of computer & telecom technology and the productivity gains that resulted for businesses. Despite the dot-com mania reaching epic proportions at the end of the decade, much of the R&D done in this period has led to products and services that have since truly changed our lives. Anyone old enough to compare their iPhone to the original Motorola Brick knows what I mean.

But the subsequent bull markets were much more a product of govt. intervention and financial engineering. Excessively easy Fed monetary policy under Greenspan and Bernanke blew serial bubbles in first mortgage, then sovereign, debt markets. When the "subprime slime" created via the Wall Street securitization machine became the first domino to fall in the

(Cont. on pg. 3)

Lessons Not - Learned

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My dad (Bill Connors) and I were reflecting in his office the other day. Him, being in the business for 28 years, and me, being 32 years old, are amazed at the severe debt this country has piled up; especially my generation.

We chuckle because saving is the building blocks for any sort of financial future, yet these days, many people just don't have any. Some contribute to their 401 k and take the money the employer may match with, but their savings stop there. Most people my age don't have any emergency account (6 months of living expenses) or money to fund an IRA or regular investment account. After their mortgage, insurances, credit cards, car notes, cell phone bills, cable, Internet and recreational spending, who can? (tongue in cheek). They feel just because somebody will sell it to them or approve them, they must be able to afford it.

As you can imagine, growing up in a household that survives and thrives on financial decisions, the idea of saving was bestowed upon me at the earliest of ages. It wouldn't surprise me if my first words were "pay yourself first." Fortunately for me, these conversations were being had, and saving became of primary importance to me as I worked while attending high school and college.

However, many people were not fortunate to have the same lessons engrained in their heads at such an early age. In fact, it is estimated that up to 2/3 of Americans would be in trouble financially if their paychecks were delayed a week. What happens if they are laid off? Many struggle to live within their means and even our government is urging us to spend to help support the economic recovery. Cash for clunkers or first time homebuyer credit sound familiar? With programs telling us to buy, who is telling us to save?

I worked at the big mutual fund company, T. Rowe Price, for three years before joining Value Financial two years ago. Now that I've seen how things operate here I'm starting to work with clients to help them save and invest intelligently. Please feel free to call on me, or have your children call on me for help with anything to do with their personal finances. They say 'luck favors the prepared'. I'm committed to helping young investors get prepared; then maybe they'll get lucky too.

(Cont. from pg. 2)
'08-'09 global financial crisis, massive federal deficits and debt followed to avert the inevitable bankruptcies and write-offs. If not for unprecedented deficit spending and now unlimited money printing to finance it at super-low rates, the stock market would not have regained anywhere near what it has since the March '09 lows. Nothing has changed in the year since I wrote Hardly Deleveraging in this space.

In order to manage through the kind of volatility we've experienced in both debt and equity markets, it's necessary to constantly challenge conventional wisdom about why valuations are headed one way or the other. Corporate profitability and int. rates are the most important variables, and both look now like they can't get better and will likely get worse. Higher rates – possibly accompanied by higher inflation – and lower earnings are a toxic combination for both stocks and bonds. After the post-election fiscal cliff fiasco, I hold out little hope of serious reform of our structural debt and entitlement problems without first passing through another crisis worse than anything seen thus far. Our cash, precious metals, energy and other defensive holdings will likely perform well in this scenario, and our dividend paying stocks with bullet-proof balance sheets should also hold up nicely too.

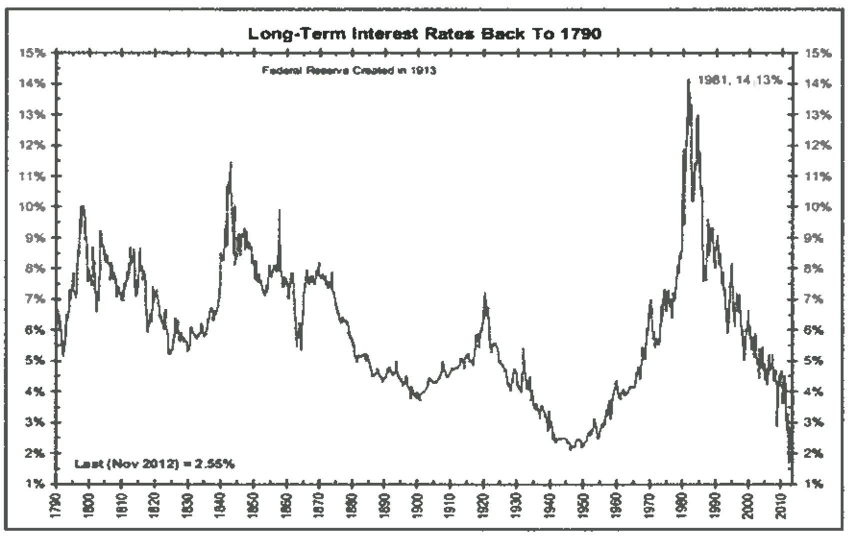
What is Wrong With This Picture?

William Mason CFA

On December 31, 1999 the S&P 500 was at **1,469.25**. At the end of 2012 it was at **1,426.19**. I know that I don't have a single managed client who has been with me since 2000 began who would trade their results for those of the S&P 500.

The reason that the stock and bond market have performed well in the last several years is exhibited in the chart showing long term interest rates. They are now at record lows of 2% and the chart goes back to when George Washington was president.

Look at the chart and tell me where interest rates go from here.



As **Warren Buffett** indicated in a ***Fortune*** article in 1999: "Interest rates. These act on financial valuations the way gravity acts on matter: The higher the rate, the greater the downward pull. So if the government rate rises, the prices of all other investments must adjust downward. If government interest rates fall, the move pushes the prices of all other investments upward."

The reason the interest rates are so low is because the Federal Reserve has been printing trillions of dollars in their quantitative easing programs and using the money to buy government bonds which forces bond prices up and interest rates down. This also forces retirees into higher risk investments.

The following are recent criticisms of the manipulation of the Federal Reserve and other central banks and I completely endorse these views.

Bill Gross

"Well ultimately government financing schemes such as today's QE's or England's early 1700s South Sea Bubble end badly.

"The future price tag of printing six trillion dollars' worth of checks comes in the form of inflation and devaluation of currencies either relative to each other, or to commodities in less limitless supply such as oil or gold."

Seth Klarman

"We must question the morality of Fed programs that trick people (as if they were Pavlov's dogs) into behaviors that are adverse to their own long-term best interest. What kind of government entity cajoles savers to spend, when years of under-saving and overspending have left the consumer in terrible shape? What kind of entity tricks its citizens into paying higher and higher prices to buy stocks? What kind of entity drives the return on retirees' savings to zero for seven years (2008-2015 and counting) in order to rescue poorly managed banks? Not the kind that should play this large a role in the economy."

Bob Rodriguez

"I view this approach as highly dangerous, misdirected and untested.

"Given that economic growth is languid at best and is likely slowing, the divergence between the stock market and economic reality cannot be sustained."

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