Capital Drain

Rick's investment opinion newsletter November, 2005 v.1 no.9

Hi Readers,

Yes, OK, it's not November anymore. But it's close, so this is still the November newsletter, and I'll also send a real December one.

Now, I know that most of you have probably been skimming over this part about hunting for names. I understand; if you weren't busy you wouldn't be subscribers. So, to get your opinion about a candidate name, I will be unsubtle:

Ask Why Investments

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What do you think of this name? Please send me an email. I'm eager to learn your opinion.
I think this does a fair job of capturing my approach to the subject: trying to ask the right outside-the-box questions in order to get answers that would not have been obvious.

Executive Summary:

Gold is screaming upward. Let it. This is probably just a speculators' little stampede which will reverse in the new year.

The Dollar has slowed or stopped its rise, and should resume its fall. Overseas investments have been doing fine despite the currency headwind, but soon that will be a tailwind.

Behavioral Finance: If you believe in it, you see Confirmation Bias all around you. That's exactly the point: we tend to notice the evidence that supports our views, and ignore what doesn't.

As before, I think everyone is best off with a **broad diversification** that includes at least **3/4 overseas** assets, reflecting the distribution of world economic activity.
These are **not the best of times**, so investors need to be in the best of securities: stick to value, to safety, to short maturities (for debt), and call me to chat if you're concerned about anything you're holding.

Above all, avoid the investments that are at all-time extreme valuations: junk bonds, developing-country bonds, and headline-grabbing stocks such as Google, Whole Foods, or Taser.

Sure, Google is doing great. So was Pets.com once upon a time. Google's a pretty good company, but at the current price you could only buy based on the Greater Fool Theory: "Sure, I paid too much, but I'll find a Greater Fool to whom I can sell it for even more!"

The Details:

"It's only when the tide goes out that you learn who's been swimming naked."

- Warren Buffett

What did Buffet mean by that, “swimming naked”?

He meant, for example, that people who bet on the tech bubble looked like geniuses—until it burst. He meant that people who have bet on rapid house appreciation or low junk-bond default rates look like geniuses now, but perhaps not forever.

The world seldom changes so much that old investing rules cease to apply. Instead, the tide comes in, and then it goes back out. The people who expect it to keep coming in forever get left high & dry.

House prices, by the way, have stopped rising almost everywhere and started sliding in some places.

For a while now I’ve been saying that **gold** is an attractive investment for a small part of your portfolio. If any of you listened, I assume that you’re grinning now. Gold is up a lot in the past half-year. But what to do now? Is it too late to hope on the train?

Yes, actually, I think it’s too late. The recent rise is too fast for me to believe that it has anything to do with fundamentals of the market or even the semi-fundamentals of peoples’ long-term asset allocations. I think it’s just the start of the year-end Silly Season. Investment managers are piling on to the one investment that’s making positive headlines as we slouch toward the year-end evaluation of their portfolio performance.

I did take my advice, so I have a chunk of money in gold (in gold stocks, actually, via the fund BGEIX). I’m watching this run-up nervously, and expect to sell if the prices start to look soft around the end of the year or the end of January. As long as the prices are rising, I’m happy to hold, but I wouldn’t want to buy at this level.

This time last year, everyone, including me, thought the **Dollar** would continue falling. Well, it rose instead. Not a lot compared to how much it’s fallen, but a fair amount. Why? Well, on the one hand, when everyone believes something, the idea may have been ridden too hard, too far. On the other hand, perhaps the macroeconomic picture of rising US interest rates and higher GDP growth in the US than in Europe or Japan made the US Dollar relatively more attractive than the Euro or Yen.

That said, the dollar’s structural macroeconomic problems that I’ve talked about, the huge lack of saving and exporting in the US and huge import of goods and money from abroad—it’s still true, and it will lower the dollar significantly, probably sooner than later. The same year-end dynamic that has the speculators piling onto gold now could have them renew their piling into non-US currencies early next year.

"   …a pocketful of mumbles, such are promises
All lies and jest, **still a man hears what he wants to hear**
And disregards the rest…"
- Paul Simon, from "The Boxer"

We all do it. The only thing different about behavioral finance students is that we *know* we do it.

"It" in this case is Confirmation Bias. We like being right, and we subconsciously put our thumb on the scale of the evidence to try to confirm that we're right. We tend to pay more attention to the facts and theories which support our views, and tune out the contradictions. We even tend to seek out the writers and pundits who agree with us, and dismiss the others as idiots.

Of course, some of the people who disagree with you *are* idiots. But not all, or always.

It is very important to make a conscious effort to seek out and expose yourself to ideas that contradict yours. Resist the human temptation to dismiss or belittle the opposing views.

At a minimum, make a note of them-- say to yourself, "there's an opposing theory I should consider." Try not to tune them out. Try not to only hear what you want to hear. Even better, try to start a habit of being your own Devil's Advocate. Sit down once in a while and try to paraphrase the argument against yourself, using your words but trying to create a statement that the other view holders would agree with. Then think about it.

This is, of course, difficult. It will take time and practice and occasional reminders to become better at it. In the long run though, it will make more thoughtful and a better critical thinker. That's laudable, but what you'll really find satisfying is that it will make you right more often. We like that.

That's it for today.

If you have any questions, please write or phone. If you want to read more, I've got a web site with old editions of this letter and some links to other interesting sites.

Please feel free to forward this to any friends or associates who may be interested.

For those of you getting this sample gratis, I charge $120/year for this newsletter. If you're not sure you like it, you could subscribe for 3 months for $40. Your checks, mailed to the address below, are always welcome, will be appreciated, and can be claimed as a tax deduction as an investment expense.

Take care,

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"Our doubts are traitors,
And make us lose the good that we oft might win,
By fearing to attempt."
--W. Shakespeare