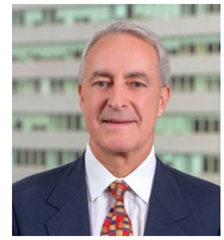
THE BORIS-KAPLAN GROUP

Thoughts for Investors



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"Don't Confuse Brains With a Bull Market"

—Humphrey Neill, the father of contrarian analysis

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"Nothing is new, it is just forgotten."

— Coco Chanel

Well, it is a new year, so that means it is time for a prediction about where the stock market is headed. The short answer is, I don't know. Instead, the topic of this newsletter is about proceeding with caution.

As many clients know, I am fond of reciting John Templeton's quote "Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria." Most investors I have asked over the past year are feeling good about the stock market but thankfully are not yet "euphoric." While I believe not being "euphoric" is a good thing for the near future of the stock market, many investors may eventually forget Templeton's admonition and become euphoric. That will turn into a bad thing for the stock market. As Templeton tells us, bull markets "die on euphoria." Warning! In my opinion, the increasing stock market volatility is evidence that the seeds of euphoria have already been planted and are indeed starting to sprout.

"Belief is when someone else does the thinking."

— Buckminster Fuller

The Templeton quote normally playing in my head has been replaced by Humphrey Neill's admonition, "Don't confuse brains with a bull market." In short, with many stocks and stock market indices hitting new highs, I believe investors should be careful about believing they possess the Midas touch, as opposed to accepting that they are the beneficiary of a bull market. Like the end of the real estate craze in 2007, the tech craze in 1999, or the end of any of the many investment "euphorias" over the millennia, today's diverse investments and investment schemes may lead some investors (and/or their advisors) to believe they have an almost magical ability to make wise investment decisions.

"Too often we enjoy the comfort of opinion without the discomfort of thought."

— John F. Kennedy

In a humorous article in the December 31, 2014 Wall Street Journal, author Robert Sapolsky advises, "Think critically about whether you're only intermittently thinking critically." In the article, Sapolsky described how a magician performed a demonstration of psychological manipulation on his son and himself. The magician gave the boy a dime to hide in one of his hands while holding them behind his back. After many unsuccessful attempts to guess which of the boy's hands held the dime, the seemingly frustrated magician took the dime back and reversed the roles. He now asked the boy to do the guessing while he hid the dime behind his back. The boy had almost magical powers as time after time he correctly guessed which hand held the dime. The magician reinforced the boy's (and the father's) belief in the boy's "skill" with multiple well chosen compliments. Then the magician revealed that he had a dime in both hands! It seems the boy had no magical powers after all.

Alas, a bull market can play similar tricks on investors.

Rather than sharing credit for investment success with the bull market, as may be justified today, it can make investors think they are investment geniuses. Compliments about their investment prowess from family and friends may add to the trick. The longer the winning streak, the more confident investors become. Bull markets may also cause investors to relax their discipline regarding investment choices or believe their investment skills may be far more extensive than they actually are. If you know what hedge funds you own but not what specific investments they actually contain, you may be guilty. According to a recent Barron’s article by Sarah Max, “Double-digit returns for the S&P (for 2014) were driven by its largest components, such as Apple, which makes up about 3.5% of the index, and which rose 40%.” Should investors count on the same performance by Apple this year and therefore expect a similar return by the S&P? I believe a bull market also causes some investors to start taking bigger investment risks, especially if they are trying to “catch up” from a lack of saving and investing in the past or from a fear of “missing out.” Large investment risks, when/if they turn negative can wipe out much past success. A 95% loss requires a subsequent 1900% gain to get back to breakeven.

“Every bad idea starts out as a good idea.”

— Old Wall Street saying

I believe another danger of a bull market is that it may spawn investment schemes that start out looking like great ideas but eventually, for many reasons, end as bad ideas. These ideas are often supported by “backtesting”, a technique whereby future success is confirmed by historical data*. Backtesting is a term to be skeptical about. The future will contain events that backtesting is unable to predict. Thus, backtesting should not be the basis for making investment decisions.

“If everyone is thinking alike then somebody isn’t thinking.”

— General George S. Patton

In my experience, the most insidious danger of a bull market is when it causes investors to lose their ability to think critically. It is a danger that I must guard against in myself. Bull markets can weaken critical thinking while strengthening “confirmation bias”, which is the tendency to search for, interpret, or simply remember information in ways that confirm one’s beliefs. It is like blocking out unwanted thoughts or whistling past the graveyard. That is why I believe what I call the “Cardinal Rule of Investing” is the most important tool for critical thinking and the cornerstone of my Investment Process. The Cardinal Rule states that for every buyer there must be a seller, and for every seller there must be a buyer, and they both think they are right. Just remember, when you are buying a great investment, you are doing so from a seller who, correctly or not, may think otherwise. Before we buy or sell, I ask myself what the other side of the trade is thinking. It may not always be possible to get an answer, but it is critical to go through the exercise of asking. I believe it is during bull markets, not bear markets as is commonly thought, that critical thinking is more important yet less likely to be used. Sapolsky learned that during the magician’s trick. He said, “If my son had had a string of failures, with the hand containing no dime, we would have instantly used Critical Thinking 101, saying to the magician: ‘Hey, open your other hand, let’s make sure both hands aren’t empty.’” Alas, neither Sapolsky nor his son used critical thinking during his son’s successful run and the ruse was on. As John Templeton pointed out, “The time to reflect on your investing methods is when you are most successful, not when you are making the most mistakes.” Like Templeton, I believe that a bull market is a more optimal time for reflection. As I outlined in a past newsletter on the Investment Process**, if your process is sound, trust it in bear markets. Wait for a bull market to reexamine and

refine it if need be because as Templeton also says, "Policies profitable for the last 10 years will not be the best in the next 10." Unfortunately, bull markets may give us all a good feeling. That, combined with our new-found "magical" investing talents, may lull us into complacency at precisely the wrong time.

"Successful investing is anticipating the anticipations of others."

— John Maynard Keynes

In summary, even as the acknowledged creative and innovative genius Coco Chanel understood, new really is rare, especially, I would suggest, when it comes to investing. We must not forget that bull markets may be more dangerous than bear markets. It is my belief that bear markets keep us on guard and vigilant while bull markets lull us into complacency until we let our guard down. Bull markets may cause us to forget what we learned from the past about questionable investments or investment schemes. On the other hand, the key to long term investment success, in my opinion, is heavily dependent on how we act during bull markets. Are we thinking critically today and, as I outlined in the last newsletter, using good judgment? If investors understand the importance of these, they should use the time during this current bull market to reexamine and refine their Investment Process. So repeat after me, "Don't confuse brains with a bull market."

"Wall Street has a few prudent principles; the trouble is that they are always forgotten when they are needed most."

— Benjamin Graham

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Hear the Other Side

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If you would like to discuss the topic of this newsletter, or our team's approach to investing, please feel free to contact us by email at al.boris@alexbrown.com.

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