



Antecedent Analysis and Strategy Counsel
Behavioral Perversity and Macro Opportunity
Brian D. Singer, CFA

Antecedent counsel is provided as internal guidance to our portfolio managers and analysts. This counsel is not a forecast and has a longer time horizon than our commentaries. We use this guidance to inform our fundamental analysis, having measurable impact on our model inputs. Antecedent counsel should assist our clients in understanding our analysis and strategies.

In our previous **Antecedent Analysis and Strategy Counsel**, which we titled *From Enthusiasm Wanes to Uncertainty Reigns* we concluded that,

This year, some of the certain adversity has dissipated, but in its place has crept the selective adversity of populism. As populist trial balloons are floated and either accepted or rejected, opportunities will develop within individual equity markets. As stated in the NFIB report, "Uncertainty [sic] is the enemy of the real economy as well as financial markets."¹

Market participants are skittish and volatility spikes are likely in 2010. Evidence of this skittishness can be gleaned from such indicators as the steep skew of below-market equity options and the relative pricing of concave high yield bonds and convex convertible bonds, among others.²

From the February 1 writing of *From Enthusiasm Wanes to Uncertainty Reigns* until July 23, 2010, the S&P 500 appreciated a lackluster 1%. Despite the apparent calm reflected in an unchanged index, the S&P 500 price has ranged between 1011 and 1220, a range of 20%. Additionally belying the calm has been a 100 basis point decline in 10-year Treasury yields from an April high of 3.99% to a July low of 2.93%, and currently 3.00%.

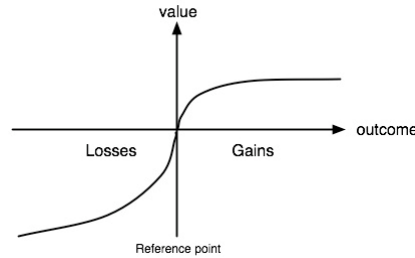
While little substantial has changed from our last **Antecedent Analysis and Strategy Counsel**, our understanding of and response to market behavior is more refined.

Understanding

Investors can't stand to lose money. Expected returns remain a positive function of risk taken, but that doesn't make the loss of money any easier to stomach. Theoretically, we know that investor utility should be dependent on the level of our wealth, but that is not the case. Daniel Kahneman and Amos Tversky's "[Prospect Theory](#)" [click article name for access] documents that investor utility is a function not of the wealth level but of wealth changes. Moreover, they explain that there is a bigger aversion to losses than there is a liking of gains (loss aversion). The figure depicts utility value as a function of gains and losses.

¹ *Small Business Economic Trends*, National Federation of Independent Business, William C. Dunkelberg and Holly Wade, December 2009, p.3.

² *From Enthusiasm Wanes to Uncertainty Reigns*, Brian D. Singer, February 1, 2010, www.singerllc.com.



In other words, when market prices decline, investors respond by gambling that the prices will rise to breakeven levels. They are averse to booking losses. However, when prices rise, investors are comfortable ringing the cash register and booking gains.

Prospect Theory implies that investors will take their profits when prices rise and allow their losses to run when prices decline. This is opposite of the old traders' adage to "cut your losses and let your profits run." Currently, we believe there are other forces at work, fear in particular, that are influencing market behaviors in a manner that overwhelms Prospect Theory.

The July 6th *Wall Street Journal* offers an observation from Jeremy Grantham in a recent speech: (Highlighting is that of Singer Partners.)

*. . . under the Fed's near-zero interest rate policy, low returns on savings are forcing retirees to take greater risks to try to gain a better income.*³

Additionally, the July 12th *Wall Street Journal* observed:

*Many individual investors were tiptoeing back into stocks in the spring. Now, they're running for cover again.*⁴

We are party and witness to the initial phase of a potentially disruptive end to the social welfare state begun in 1889 by Otto von Bismarck with the Old Age and Disability Insurance Bill. Interestingly, the intent in 1889 was to provide pension annuities only to those who lived well beyond their expected life spans. The European social welfare state and recent US move in that direction rode waves of demographic sustenance to the current bloated and unsustainable state. Individuals have become acutely aware of the inability of shrinking developed country labor forces to support the expanding social burden that retirees and the post-labor force population. Individuals discount state-provided pension annuities at tremendously high rates and, struggling to preserve retirement living standards, incur risk in response to market rallies and bail out when it declines.

Many professional investors have painted themselves into the same corner, hedge funds in particular. Consider a comment from Chris Jackson, a hedge fund investor at **SFG Asset Advisors** in San Francisco, in the same July 6th *Wall Street Journal* articulating the expectations common to hedge fund managers:

*The firm's "fund of hedge funds" probably generated a small gain in the first half, he noted. "That's OK," Mr. Jackson said. "The idea is to not lose money - then you have some dry powder to attack the second half of the year. Managers that have been defensive probably have cash to trade on the front foot for the rest of the year."*⁵

³ *The Wall Street Journal*, "Hard Knocks from Easy Money," by George Melloan. July 6, 2010.

⁴ *The Wall Street Journal*, "Small Investors Flee Stocks, Changing Market Dynamics," by E.S. Browning. July 12, 2010.

⁵ *The Wall Street Journal*, "Edge Funds Sidestep Big Losses in 2010," by Alistair Barr. July 6, 2010.

A *Bloomberg* article on July 8th provides additional color. After succumbing to an 8% S&P decline in May and a compounding June decline of an additional 5%, *Bloomberg's* headline read, "Hedge Funds 'Frozen in Headlights' Scale Back Trading."

"It's all about capital preservation at the moment," said Amit Shabi, a Paris-based partner at Bernheim Dreyfus & Co., which farms out client money to hedge funds. "The losses of 2008 are still fresh in investor's memories and so managers should be cautious."

Also in *Barron's*, from the venerable Barton Biggs, who runs the New York-based hedge fund Traxis Partners:

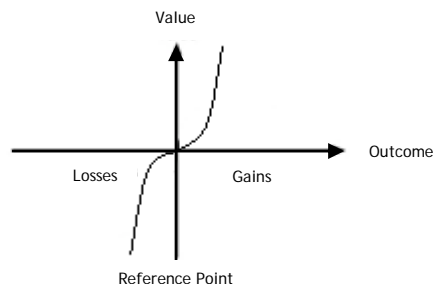
"I'm not wildly bearish, but I don't want to have a lot of risk at this point," Biggs, who manages \$1.4 billion, said in a telephone interview. "I'm not putting my money into anything. I'm raising cash."⁶

Yet, less than three weeks later, in a *Bloomberg* article, Barton Biggs responded to a 7% SD&P 500 rally by increasing his fund's equity exposure to 75 percent:

"I've definitely changed my mind to the degree of risk out there," Biggs said in a radio interview.⁷

These quotes offer no proof; rather, they provide color and assist our understanding of market behavior and communication of our market behavior analysis. This analysis includes not only examination of "market commentary", but also investigation of directly observable behaviors and dialog with other investors.

Currently and we believe for the near future, fear appears to be overwhelming the normal behaviors documented by Kahneman and Tversky. Rather than loss aversion investors seem unwittingly to show signs of "loss seeking" behavior, or the desire to crystallize losses before they compound. Moreover, they covet gains that can generate retirement funds or performance fees.



In a behavioral model dominated by crowd fear and greed, higher asset prices lead to increased risk through asset purchases and lower asset prices lead to risk seeking asset sales. These behaviors protract recent price moves, both up and down, over short horizons. This crowd conduct is momentum-based, price chasing behavior.

⁶ *Bloomberg*, "Hedge Funds 'Frozen in Headlights' Scale Back Trading (Update1)," by Saijel Kishan and Katherine Burton. July 8, 2010.

⁷ *Bloomberg*, "Biggs Says He's 75% Net Long on Stocks After Changing Mind on Risk Outlook," by Thomas R. Keene and Nikolaj Gammeltoft. July 26, 2010.

As Woody Brock observes “the current turning point is not due to news *per se*, but rather to a shift in the ‘belief structure’ of the general public - and of financial market participants as well.”

Now, market participants adhere to the traders’ adage. This would be fine, except that it is occurring *en masse*. As a crowd behavior, selling when the market declines to limit losses and buying when the market rises so as not to miss a rally merely introduces volatility around the current market price equilibrium. This we believe is a significant contributor to equity market volatility in the short run, triggering 20% swings during short periods devoid of market direction.

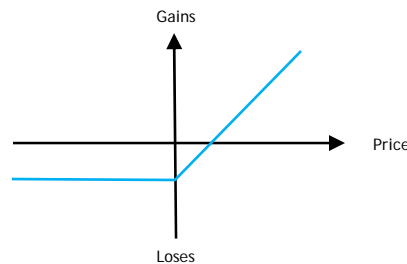
As we are wont to do at Singer Partners, consider the incentives behind this behavior. During the salad days from 2002 to 2007, alternative asset managers promised superior performance without significant downside risk. The credit crisis of 2008 and the May 2010 “flash crash” have laid bare these claims for an overwhelming majority of alternative investment purveyors. Now, the pressure is intense to produce returns for clients and carry for employees, without another inopportune high beta performance fiasco. Thus, this class of market participant incentivized to be little more than momentum players attempting to replicate a call option payout without securing the option premium. Of course, this is a fool’s errand that is self-defeating at best and both self-defeating and market destabilizing at worst.

Individuals across the wealth spectrum have witnessed the erosion of retirement savings, legacies, and estates. Like the alternative investors who promised more than they could deliver, individuals relied on inordinately high investment returns to finance profligate spending habits and overly optimistic visions of retirement. Governments supported the ruse by promising state support that inevitably would not be deliverable. Now, individuals can’t afford to experience wealth erosion or to miss the potential of an equity market rally to bail them out of retirement savings holes. Hedge funds must deliver promises that tax the credulity of their claims. Finally, governments have compounded these behaviors by playing into and magnifying the fears of investors globally.

Singer Partners Action

Singer Partners uses fundamental values of asset classes, markets, sectors, themes, and currencies as a beacon in the storm. In turbulent waters that trigger fear and kindle greed, the beacon of fundamental value guides our investment strategy toward superior performance. However, market behavior analysis affords the opportunity to understand the machinations of market participants and the gyrations of market prices. Consequently, we anticipate responding to short-term price moves to increase and decrease risk positions consistent with observed value/price discrepancies. We have and will have a tendency to be more active than typical and to fade short-term price changes.

Additionally, market behavior reflecting swings between fear and greed engenders large swings in the implied volatilities priced in options. It is clear to us that a significant share of the market is attempting to replicate the performance of an equity market call option.



First, the option implied volatility skew reflects high prices for protection against an equity market price decline. There is strong demand for asset price insurance, or downside protection. Second, a comparison of convertible and high yield prices suggests that same desire for upside equity price exposure without downside risk. Convertible bonds are convex, providing exposure to equities through the option to convert the bonds into equities at specified prices. High yield bonds on the other hand, provide income now, but are vulnerable to poor equity asset performance. Despite the SEC Chairman Cox-induced implosion of the convertible bond market in 2008, prices have rebounded, no longer offering relatively attractive investment opportunities. High yield bonds, on the other hand, have performed well as they recovered from the credit crisis, but the asset class affords an attractive investment opportunity relative to fundamental value.

While downside performance is limited and upside is available, the cost of the option, either directly or through replication, is significant and performance impeding. We prefer to provide performance that replicates a call option, but as it does not come without cost, we will focus on fundamental values and be measured in our activities. The expected outcome is superior investment performance over the coming months, perhaps years, and portfolio returns that are mitigated on the downside and enhanced on the upside, or convex. However, Singer Partners investment performance is likely to be more volatile than many of our competitors. We expect this performance variation and want to make sure that our clients understand this volatility and its expected benefits.