

“Risk versus Reward”

Psychologists have uncovered a surprising number of idiosyncrasies from making the soundest choice in many situations. These lapses explain some of the mysterious up and downdrafts that can lift and lower stock prices. Understanding them can make successful investing easier. The most important findings arise from answers to a pair of questions.

The first: If faced with the prospect of two possible gains, which would you choose?

- A 100% chance to win \$3000.
- An 80% chance to win \$4000.

Asked this question, most people choose the guaranteed \$3000, even though the second choice has higher value according to probability theory. The value is determined by multiplying the second chance of winning, or 80%, by the \$4000 the winner stands to gain (80% of \$4000 is \$3200). So in the long run you come out ahead by making the second choice consistently. Most people are bothered by the 20% chance of getting nothing in the second choice, which tells psychologists what stock market theorists knew all along: That investors in general prize certainty and abhor risk.

It's not that simple, however. When people are confronted with prospective losses, quirky psychology turns them into riverboat gamblers. That fresh discovery became clear from another question. Which would you choose?

- A certain loss of \$3000.
- An 80% chance of losing \$4000 and a 20% chance of losing nothing.

Most people will gamble on the second choice, which offers a 20% chance of going unscathed, even though it is riskier (again, 80% of \$4000 is \$3200). Because people's horror of losses exceeds even their aversion to risks, they are willing to take risks – even bad risks. Contrary to what's been believed, risk aversion is not always the guiding light of decision making.

To measure just how deep the fear of loss runs, psychologists follow up this pair of questions with another. Students were invited to wager on a hypothetical coin toss: Heads you win \$150; tails you lose \$100. Though the potential payoff is 1½ times the possible loss, most students refuse to bet.

How can otherwise rational people act so unwisely in the face of promising moneymaking opportunities? Despite the outsize reward for taking this risk, the researchers say, most people are put off by the 50% chance of losing. Loss aversion is a surprisingly powerful emotion. So great, in fact, that it keeps people from accepting good bets, both in coin flipping and in selecting stocks.

... John J. Curran, *Investors' Guide* (1987)

Betting indeed, as David Sklansky wrote in the book *The Theory of Poker*: “Any time you make a bet with the best of it, where the odds are in your favor, you have earned something on that bet, whether you actually win or lose the bet. By the same token, when you make a bet with the worst of it, where the odds are not in your favor, you have lost something, whether you actually win or lose the bet.”

So, as most of you know, Andrew and I attended, and presented at, the Raymond James' national conference in Washington, D.C. It's always good to get together with the Raymond James “family”, and last week's gathering was no exception. Amid the presentations, lunches, dinners, cocktails, and general conviviality, we had the pleasure of talking to some of our financial advisors (FAs) and their clients. In one such repartee, the advisor asked me to talk to her client who continues to sit on mountains of cash and refuses to invest. His reasons were the same ones we always hear at events, so I related the points as to why we think this secular bull market will continue for years, but it was all to no avail. My parting shot to the advisor and her client was, “Call me and tell me when he decides to buy stocks, because then I will become a seller”, which got a big laugh from both of them.

“Risk versus Reward,” what an interesting topic and one that is extensively covered in Ben Graham’s book *The Intelligent Investor*. The operative quote from that book is this, “The essence of portfolio management is the management of *risks*, not the management of *returns*.” Dr. Graham closes that thought by saying, “All good portfolio management begins and ends with this premise.” Yet managing risk is one of the hardest things to get investors to do, and that is the sad reason many participants remain scared of stocks, because they didn’t manage the risk back at the beginning of 2008. Recall, there was a warning signal sounded by Dow Theory with the “sell signal” of November 21, 2007, just like the Dow Theory “sell signal” of September 23, 1999, but I digress.

As stated, there is little doubt in our minds that the secular bull market is alive and well with years left to run, but most do not believe it because only a few of us have ever seen a secular “bull market”. Indeed, like our example of the advisor and her client who think our conclusions are *reductio ad absurdum*, so they scorn the concept that stocks have years left to rally. Unfortunately, many folks have felt that way for the last eight years and remain underinvested. Also unfortunately, many participants are more concerned with the short/intermediate-term directionality of the equity markets than the long-term, net-worth-changing implication of a secular bull market. To respond to those concerns, our intermediate-term model continues to flash bullish readings, while our short-term model suggests there is still the potential for some downside consternations this week. We think if that weakness arrives, it should be bought.

The call for this week: Last week, the S&P 500, S&P 400, S&P 600, Nasdaq Composite, and the Russell 2000 made new all-time highs. The exception was the D-J Transportation Average, which pulled back from its all-time high late in the week. When the S&P 500, the Dow Transports, and the Russell 2000 make new 52-week highs on the same trading day, (which happened last week for the first time in at least three months), the median return over the next three months has been +3.95%, according to Bespoke. Importantly, Buying Power is rising and Selling Pressure is declining, and Buying Power is very close to crossing above Selling Pressure in the charts. All of this positive action is being confirmed by the Advance/Decline Line as breadth continues to improve (the NYSE A/D Line tagged new highs last week). These kinds of metrics are consistent with an equity market where the pullbacks are usually short and shallow. Meanwhile, 65% of companies reporting earnings have bettered the estimates and 67.1% have beaten revenue projections as the transition to an “earnings-driven” secular bull market continues to gain traction. At 5:22 a.m., the preopening S&P 500 futures are down 4.5 points because Japan’s Nikkei fell 1% on the 26% slide in Abe’s approval rating. Moreover, after an expiration (last Friday), U.S. stocks tend to open soft on position squaring. However, with this week’s FOMC and Yellen’s dovish flip, any weakness should be bought.

P.S. - We are doing a 4:15 p.m. call today with BlackRock’s portfolio manager Michael Fredericks, the PM for the BlackRock Multi-Asset Income Fund (BAICX)

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