Fama Fiduciary
WEALTH LLC

Website: www.famawealth.com *E-Mail:* andrew@famawealth.com

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"Men nearly always follow the tracks made by others and proceed in their affairs by imitation…"*—Machiavelli*

To our clients and friends:

In late October, I attended a Fidelity Investments conference in New York City. The majority of the sessions at the conference focused on the concept of ***risk***. One session was particularly captivating. The speaker, Dr. Ren Cheng, had placed five metronomes on a wooden plank. A metronome is a device used in music to keep a steady beat—it produces regular, metrical ticks and is used to set a melody. The plank holding the metronomes was then laid across rounded cylinders arranged in a row on a flat table.

Dr. Cheng then manually started up all the metronomes on a staggered basis. He first wound up and then triggered each one—purposely starting each one out of sync with the others. Thus, all five were ticking in irregular patterns at first. But after a few minutes passed, each one began to slowly synchronize with the others. And moments after that, all five were fully synchronized with one another—and therefore ticking in unison.

The audience of advisors and investment managers was baffled. What was the point of Dr. Cheng's demonstration and what did it have to do with risk?

The Millennial Bridge and Metronomes

Before he would explain the purpose of the metronome display, he showed a short video of the nearly disastrous Millennial Bridge opening in London on June 10, 2000. As more people walked onto the bridge that day for the first time, the more it began to sway side to side, and the more it swayed, the more people adjusted their steps to remain in sync with the other walkers. This synchronicity nearly caused a catastrophic collapse of the bridge and it was closed almost immediately thereafter, the same day it opened.

The point of his demonstration with the metronomes (and of the bridge video), Dr. Cheng stated, was to suggest to the audience that investors also tend to move in the same direction, or in groups. This is true even when they might have entirely different investment objectives from one another.

The phenomenon demonstrated by Dr. Cheng with the metronomes was the same phenomenon present in the Millennial Bridge near-disaster. And this same pattern of behavior may once again be taking hold among investors as we enter 2014.

<u>Herding Behavior and Risk</u>

By using the Millennial Bridge illustration, Dr. Cheng wanted to show how this type of group behavior—a sort of "herd mentality"—might ultimately lead to dangerous conditions being created for investors following in lock-step with one another.

Herd behavior refers to the tendency for people to mimic the actions of a larger group of people. An investor may follow the herd because he or she feels an intuitive sense of conformity. Aligning oneself with the consensus of a large group going in the same direction is more comfortable than making an alternative, less-popular choice.

Anyone connected in any way to the financial world knows that the market has had a huge run-up through the end of 2013—this after taking off from the bear market bottom in March 2009. When financial markets rise, money flows into those markets. And alternatively when markets falter, many investors cash out. Why is this?

As Machiavelli famously stated in the quote above, people tend to mimic the actions and behavior of the majority.

<u>Following the Crowd—Is There Safety in Numbers?</u>

Another reason market participants often follow the road well-travelled is the perception that a large group of people going in the same direction ***must*** have access to different information, and therefore ***must*** be right. How could so many people be wrong at precisely the same time?

It's worthwhile to illustrate the absurdity of the herd-induced level of stock market participation during the late 1990's. It turns out that January 2000 represented the absolute peak in the number of media headlines announcing the "bull market in stocks". In response to those headlines, the stock market experienced a record net inflow of nearly ***$50 billion*** into equity mutual funds the very next month—in February 2000.

The end result is that full-blown herd behavior often contributes to asset (or stock) price bubbles that eventually burst. Furthermore, the later the point in time that one chooses to follow the herd, the greater the risk that is assumed.

In addition, the lure to chase outsized returns in a popular security or asset class (for example, tech stocks in 1999 and housing in 2004-2006) could prompt an investor to move from a diversified portfolio to a significantly more concentrated one, which also increases portfolio risk and volatility.

<u>Behavioral Finance and Bear Markets</u>

As we've discussed in previous newsletters, behavioral finance plays a major role in modern investing. Emotions can drive investors to behave in ways that are potentially detrimental to their long-term goals. By quickly reviewing the graph from last quarter's newsletter, we know that euphoric investors buy high, and frightened investors sell low.

This principle is applicable to any ***market***—a market being defined as an exchange or medium in which things are bought and sold. And this emotion-driven tendency towards buying high and selling low applies not just to housing or to stocks. It has been happening for centuries. One need only think back to the days of the Dutch tulip mania to see this same principle demonstrated throughout recorded history.

As recently as 2008, this same self-destructive behavior was on display once again. To this day, there are still thousands of investors on the sidelines, sitting in cash. They had moved to relative "safety" in 2008 and 2009 at the bottom of the bear market.

This is also the same pattern that transpired in 2002, at the bottom of ***that*** bear market. And as they did in 2002, investors who have kept long-term capital tied up in cash from March 2009 to the present date have likely missed out on considerable gains.

Contrarian Investing

Switching tracks for just a moment—we don't normally use graphs and charts in these newsletters. But in this one instance, I couldn't resist putting this chart up. This is a chart of the S & P 500 index over the past 20 years. My 21-year old daughter was a toddler taking her first steps when this chart began in 1993. Now that is ***"long term"!***

Earlier in this letter, I pointed out that in February 2000 record net inflows of *cash flowed into stocks.* This occurred at approximately the 1552 level in the chart above. And at the 768 level in the chart (in late 2002) the percentage of mutual fund assets held in cash or money market funds hit all-time record peaks—just prior to the next bull market.

The same result transpired in early 2009 at the absolute—and final—bottom of the bear market (see level 666 in the above chart). At this point, cash reserves and money market funds held in mutual funds settled at all-time highs, far exceeding the previous record levels of late 2002. In other words, *stocks had now flowed back into cash*!

It is apparent from this chart what actually happened both in 2002 and in 2009, right after investors herded to the perceived “safety” of cash and money markets. The market rocketed ahead—and investors ***not*** following the herd made a lot of money.

There are also many other lessons to be learned from this single chart. You may have some thoughts of your own. One obvious message for me is that those who invest for the long-term are handsomely rewarded (note the enormous increase in the value of the S&P 500 index from 1993—when it was well below the 500 level—to the present).

I distinctly recall coaching each and every one of my clients in late 2008 and early 2009. My overriding message was to remain steady and poised and not to panic out of the market by going into cash and money market funds. None of my clients bailed out.

Using charts, graphs and various professional research materials, I implored my clients to understand and accept what history has told us over and over. Namely, that if you lock in your paper losses by pulling out of the market during a severe decline, you will have sabotaged your long-range investment plan and it will take significantly longer to recoup those losses—unless you have the unique ability to predict the market bottom.

Conclusion

I will close this newsletter with a quote from a highly-respected mutual fund manager who comes from a very long line of money managers—the Davis family. Christopher Davis, son of the legendary fund manager Shelby Davis and grandson of Shelby Cullom Davis Sr., who founded Davis Selected Advisers in 1947, has been nurtured in the family business since childhood. He is now managing Davis funds and compiling an enviable record. Christopher Davis made this comment in very early 2013, when many prominent naysayers continued to doubt the market’s ability to move higher:

> *“The cult of equities still seems to be dying. When you think of all of the uncertainty and upheaval that stocks have gone through in the last decade, you’d think from reading the headlines that stock investing would have been a disaster. But through two recessions, two wars, the greatest decline in residential real estate in history, the Euro crisis, the fiscal cliff, and everything else, stocks have still returned about 7% per year over that time period. People should look to those numbers as a sign of the resiliency and durability of equities. Instead people feel only the uncertainty, only the fear, and consequently, people flow to so-called “safe harbors” such as fixed income, when the risk there seems much higher than the risk in equities at this time.”*

Sincerely,

Andrew J. Fama, JD, AEP, RFC, MHA, Registered Fiduciary
Principal, Fama Fiduciary Wealth LLC, Registered Investment Advisor

****Past performance is no guarantee of future results**Nothing contained in this quarterly newsletter should be construed as investment advice****