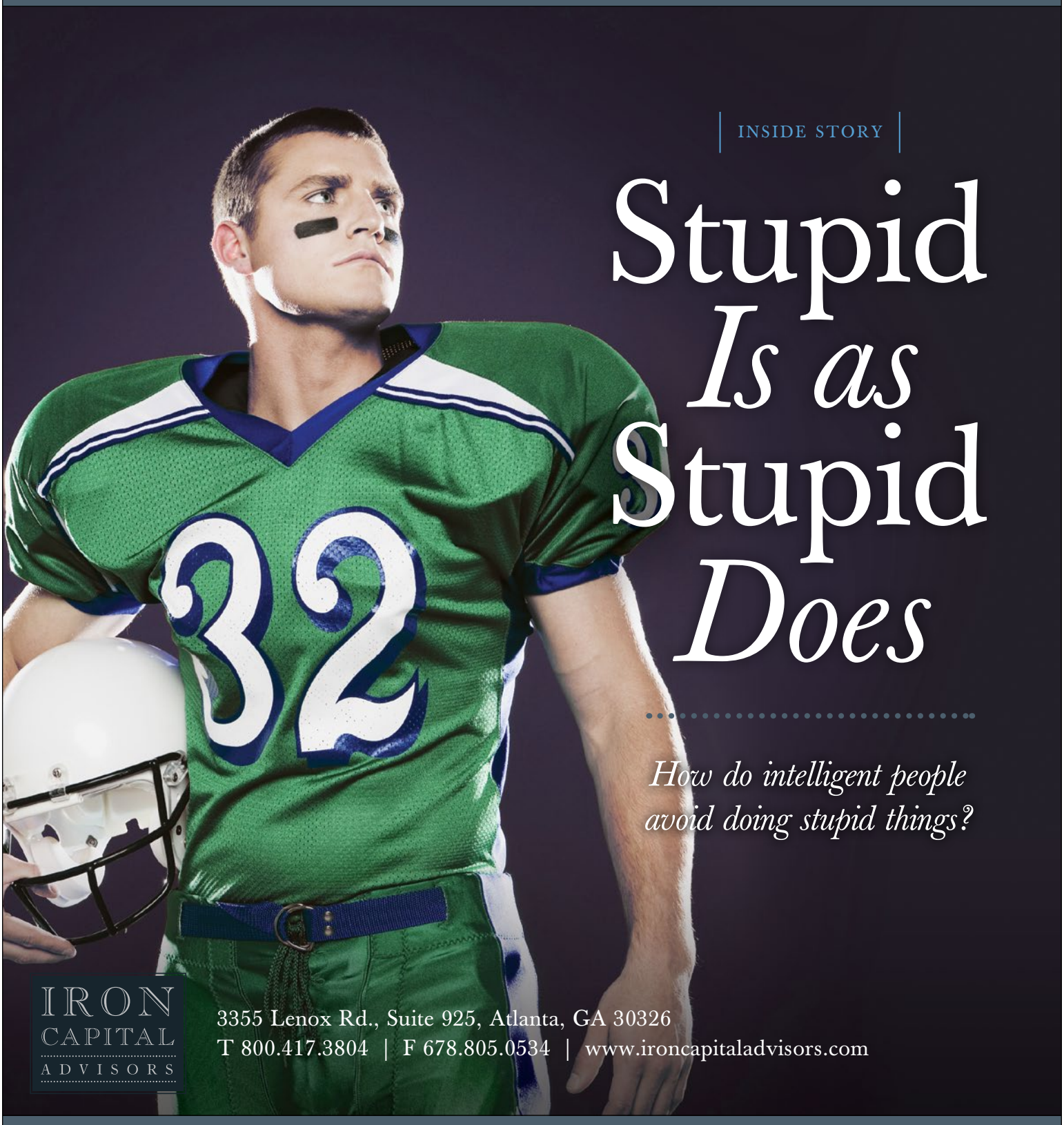
The Quarterly Report

A QUARTERLY PUBLICATION OF IRON CAPITAL ADVISORS | Summer Issue | July 2015



INSIDE STORY

Stupid *Is as* Stupid *Does*

How do intelligent people avoid doing stupid things?

IRON CAPITAL ADVISORS

3355 Lenox Rd., Suite 925, Atlanta, GA 30326
T 800.417.3804 | F 678.805.0534 | www.ironcapitaladvisors.com

THE TEAM BROKE HUDDLE AND CAME TO THE LINE OF SCRIMMAGE. Their star quarterback, Osborne, took the snap and dropped back to pass. The pocket broke down and he scrambled to his right. Seeing no one open for a pass Osborne tucked the ball for safety and decided to run for what yardage he could get. Then out of the corner of his eye he saw his fullback break open. He tried to get the ball back up in a throwing position but the defense was on him, so at the last second he attempted what could only be described as a basketball-style chest pass vaguely in the direction of his fullback. The ball floated right into the hands of the other team's cornerback, who ran it back for a touchdown.

Stupid *Is as* Stupid *Does*

The rest of the Osborne family sat in the stands, somewhat in disbelief as to what they had just witnessed. An avid fan sitting directly behind them stood up and started shouting, "Stupid! Stupid!" Osborne's loving and protective older sister had heard enough. She stood up, turned around and announced to the avid fan, "That's my brother!" At this time, the senior Mr. Osborne put his arm around his daughter, tried to calm her down and said, "Well, you do have to admit, that wasn't the smartest thing your brother has ever done."

No, it wasn't me. This true story was about my brother, who is a successful attorney in South Florida and, this one embarrassing episode aside, a very intelligent guy. But even the smartest among us occasionally does something that can only be described as, well, stupid. For most of my life I have assumed that everyone recognizes this as a fact of life. Then one day I was trying to put together one of those "some assembly required" toys for my son and I made a mistake. I looked at my son as I was fixing it and said, "That was stupid of me." My son looked at me in horror and informed me that stupid is a bad word.

Until that moment I thought I knew all the bad words that I did not want my children to learn from their father (most of which have four letters, not six.) I tried to explain to him, as was taught to me in a different era, that calling someone stupid is bad, but stupid itself is not a bad word. Smart people do stupid things all the time, usually when in a hurry or distracted and not fully thinking. I gave up and now try to use the word silly when describing stupidity.

Even the smartest among us occasionally does something that can only be described as, well, stupid.

I understand why a teacher would tell children that stupid is a bad word, especially at a young age, as one of the greatest ironies of childhood innocence is that children can often be cruel to one another. Of course, in the real world stupid happens all the time. We've all seen it and most of us have done it – I know I have. It happens in sports, when many games are determined by an opponent making a mistake in judgement. It happens in politics, when a promising politician says something carelessly and all of a sudden his career meets its end. The one place it may happen the most often is in my world: the world of economics and finance.

Traditional economics and finance assumes rational behavior. Of course humans are capable of being rational, but this often requires energy and focus. Many times in our busy lives we feel like that quarterback who is being rushed out of the pocket. Our modern lives do not usually lead to actually being chased down and tackled, but between work, family, and our "smart" phones that keep beeping and vibrating at us, constantly reminding of us of the twenty things we were supposed to do today that still are not done, we may feel just as overwhelmed.

It is no surprise then that experts have found that the first thing most people feel when presented with an investment opportunity is reluctance. How are we supposed to slow down enough to use our powers of rationality and make smart decisions? We feel like that is just too hard, so we are reluctant. We don't want to make a mistake, and although at some level we may recognize that doing nothing might actually be the worst thing, we just feel more comfortable not having to move.

We are like that quarterback in the pocket protected by all those big linemen, but eventually that pocket of protection will start to break. Co-workers, friends, neighbors, or even family members who were not reluctant for whatever reason start pointing out how well they are doing. Our reluctance slowly turns to optimism.

Then we go online. Our modern world gives us the ability like never before to conduct what passes as research: "Google it." We can post questions for our friends on social media. But there is a dark side. All of that connectivity can lead to seeking confirmation more than true enlightenment. One of my friends recently put it best when discussing social media: no one is out there seeking to understand; they are out there to have their views amplified, and if anyone dares question them then to shout them down. So people go out there seeking confirmation of their optimism, not seeking truth.

One of the quirks of the Internet is that it will give you what you seek. In this case that causes optimism to turn into excitement. As one stays in his echo chamber getting more and more positive feedback his excitement eventually turns to exuberance, and it is a this moment that the inaction ceases and the investor makes the investment.

All around in the busy world he will see glimpses of positive feedback. He will believe that he has done the right thing, the intelligent thing. Then reality hits home. Bad news, previously ignored, comes to light. Perhaps sub-prime mortgages start to default, or maybe a hedge fund run by a smaller Wall Street bank folds. The reaction will usually be to rationalize, "It's just sub-prime and that is a small part of the market," or "It is just one hedge fund." In other words he is in denial. After all he is intelligent, he did his homework, there is no way he is wrong, there is no way he did something stupid.

Well the hits keep coming. That small firm that ran the failed hedge fund? Now the whole firm is in trouble. This is getting a little scary. Fear sets in, but fortunately regulators come to the rescue and arrange for that troubled firm to be bought by one of its stronger competitors. But, now an even larger

firm is in trouble. So are two others. This is getting desperate, what does the investor do? He now has a loss and he doesn't like taking losses, which is like admitting a mistake.

Then it happens: the larger firm goes down, and another is on the brink. The pocket has completely broken down and big scary defensive linemen are on your tail. Panic sets in, he runs for it, and as all seems lost he finally capitulates, just throwing the ball up for grabs. The other team catches it and runs it back for a touchdown. The Monday morning quarterback in the stands starts shouting, "Stupid, Stupid!"

Sound familiar? It should, because it happened just a few years ago. That small firm was known as Bear Sterns, the larger one Lehman Brothers, the two others, Countrywide and Washington Mutual. This is what happened. I could do the same thing with the tech bubble, and we may be seeing something similar with Greece and China today.

Where do we go wrong? First of all we have too many Monday morning quarterbacks. I sometimes joke with friends that our national pastime used to be playing baseball, and now it is watching football. Technology has led us more and more to be spectators in life instead of participants. We have told that story about the fan calling my brother stupid so many times in my

» *Continues on next page...*

REVIEW *of* ECONOMY

Three steps forward two steps back. First quarter GDP shrank by 0.2%, we expect the second quarter number to be better, but this pattern is getting a little old. A few really good quarters followed by a complete halt. This is what the new normal has been, 2 to 2.5% growth on average but the growth has been lumpy.

The official unemployment rate dropped to 5.3% in June, after going back up to 5.5% in May. The weekly numbers have been more volatile of late as well. The volatility in the numbers could be a sign of the improvement slowing down. Fingers crossed that is not the case.

Inflation has remained barely positive. Many are worried about when the Fed will raise rates, but it won't happen until inflation gets nearer to the 2% target. If they do raise rates it will be nominal and more of a test for market reaction than anything else. +

REVIEW *of* MARKET

A rough ride to nowhere, again. The S&P 500 ended the quarter up 0.28% but was losing ground in the month of June. Small company stocks did better up 0.42% but international markets were the best place to be up 0.84%.

Bonds were down with the Barclays Capital U.S. Aggregate Index off 1.68%. High yield bonds did better during the quarter with the Merrill Lynch High Yield Master Index down only 0.04%. The fear of rate hikes dominated in the quarter.

Greece and China dominated the headlines in a negative way, but international stocks as represented by the MSCI EAFE Index remain up 5.88% year to date. +

MARKET *forecast*

We continue to be cautious about the near term. However, we are still confident in the longer term. Valuations on equities are getting closer to fully valued. The rotation we expected this year seems to have begun, as areas left behind last year have done better.

U.S. large cap stocks are still attractive. International stocks look better from a valuation perspective. Emerging markets remain the most attractive on a valuation basis. Small company stocks remain overvalued.

Bonds remain our biggest concern over the long term, but they are still a shelter in the storm when the market does go down. +

» *Continued –*

family that it seems like yesterday, but fortunately for my brother it happened in the mid-1970s. I can't imagine what the reaction would be like today with social media. One thing that always helped with our family was that we understood that the fan really had no idea what it is like to actually be a quarterback.

Spectators sit back and offer criticism after the fact, which doesn't take any courage, knowledge or understanding – it is easy. Let's face it, the players usually cannot hear what the spectators are saying anyway. It's just noise. This happens to the investor as well: Financial advisers who don't practice what they preach, lecturing clients about this or that. Financial reporters, who know far more about journalism than investing, give advice that always sounds good in hindsight, even if it contradicts what they said last week. It's all noise.

The reality of today's world makes it increasingly difficult to overcome reluctance; at the same time, it makes it increasingly easier to fall into denial. All of the big mistakes investors make are driven by these two emotional states. I have long considered it our most important job to help our clients avoid these two things. This is why we emphasize prudent investing. It is much easier to avoid reluctance if one knows what one owns.

Investing from the bottom-up helps one gain an understanding of what is really happening; it gives us a tool to separate news from noise. Analyzing individual investment opportunities automatically drowns out the noise and helps guard against feedback bias. A company's financial results are what they are regardless of what might be going around on social media.

How do intelligent people avoid doing stupid things?

We take our time.

Absolute return-orientation helps avoid the excitement trap. We don't need to beat anyone or anything to get where we are trying to go. In this way investing is more like running a marathon than competing in a football game: for the vast majority of marathon runners, to finish is to win. If they beat their personal best, their personal goal that is victory regardless of what other runners are doing.

Risk aversion means never being in denial. Lots of things that shouldn't have any impact on the markets end up causing havoc. Small things can have a big impact, and big things sometimes have little impact – one never knows how people will react. This is when it is important to know what one owns and understand that even if short-term trading turns negative, patience will be rewarded because what she owns still has value. This is also when it is important to have disciplined risk controls, realizing that it is better to sometimes be defensive and miss out on upside market reversals than it is to be in denial and end up capitulating.

How do intelligent people avoid doing stupid things? We take our time. We don't get rushed or scared or distracted. We make prudent decisions. Is our way of investing the only way? No. But it works for us and our like-minded clients. There are other strategies, alternatives, indexing, sector rotation, market timing, etc. But all of those run the risk that one day a Monday morning quarterback might look at what they've done, jump up and yell, *"Stupid, Stupid!"* I like our way better.

CHUCK OSBORNE, CFA, *Managing Director*