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INSIDE STORY | *Irrational Behavior*

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IRRATIONAL BEHAVIOR

by Chuck Osborne, Managing Director

I was sitting at home the other night with my wife and we rented a movie I had not seen in a long time. It was the 1997 hit "Men In Black" featuring Tommy Lee Jones and Will Smith as secret agents policing alien activity here on earth. The existence of these aliens here on earth of course had to be kept top secret to avoid a panic. Agent J (Will Smith) thought the MIB should just let everyone know about the aliens – after all, as he said, "People are smart, they can handle it." Agent K (Tommy Lee Jones), who was older and perhaps wiser, responded, "A *person* is smart. *People* are dumb, panicky, dangerous animals, and you know it." How profound. Agent K could have had a very lucrative career on Wall Street.

When it comes to investing, the individual investor may be intelligent, but the market? The market is a dumb, panicky, dangerous animal, and you should know that. This year has been a classic example. In the first quarter, the market took off like a rocket for no real reason, and to make matters more confusing, it was led by the most overvalued, lowest quality

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sectors. In the second quarter, the market corrected based on inflation fears. The fear of inflation was treated by the market as a shocking surprise. (Evidently, too many market gurus live in Manhattan and never drive their own cars.) The only surprise about core inflation rising is that it took this long to start happening. Higher energy prices eventually will impact other prices in the market. This should not be a surprise even to Wall Street. So, what is really going on?

Unfortunately, the market is just irrational, at least in the short-term. The market tends to overreact, and then correct. This is the essence of the "market cycle". The irrational behavior of the market is not new. Robert Shiller, the Yale professor and best selling author of "Irrational Exuberance" (a title he stole from former Fed Chairman Alan Greenspan), wrote extensively about how irrational the market can be. The famous economist John Maynard Keynes once warned, "The market can stay irrational much longer than you can stay solvent."

So what is an investor to do? I believe we should hold on to the knowledge that eventually the market does get it right. In the long-term the market does a good job of valuing assets fairly. In the short-term we should always remember Keynes' warning. This is why having a well-defined investment discipline is so crucial.

One of the most common mistakes we find when we take over portfolios for our new clients is that often there is no discernable investment strategy in place. We usually find a random hodgepodge of holdings with no evidence that anyone ever thought about overall portfolio construction and/or risk management. Individual investors tend to make investment decisions in a vacuum. For example, when I am at a party and someone starts asking me investment questions, it is usually something along the lines of, "What do you think about Dell?" or "Should I buy GM bonds?" I used to tell them the truth – that it depends on what the rest of your portfolio looks like, and that you have to decide not only whether to buy but also how much to buy, in what account you want to buy and what to sell in order to buy. However, I have found that telling the truth at cocktail parties often means you will be drinking alone, so now I just try to change the subject.

Portfolio management is much more than just making decisions on investing in this asset and/or that asset. Portfolio management involves creating a whole portfolio where every part has its function and making decisions is based on a sound investment philosophy and controlling risk. Controlling risk is arguably the most important element in portfolio management, yet most investors do not really understand what it means. When you talk to most investors

about controlling risk, they start talking about buying investments that are conservative when considered on an individual basis, but what we are talking about is much more dynamic than that. Controlling risk entails thinking about each investment in terms of your overall portfolio.

The portfolio management process should begin with a declaration. You should put in writing a carefully considered investment policy statement, which should include your objective. Where are we going? Most of our clients do not invest for the sake of investing. They are investing to fund their retirement or their children's education, or in some cases just to have more money than their neighbors. Whatever the motivation there is a goal, and that goal greatly impacts how the portfolio should be managed.

Once we know what the goal is, we can determine the return required to achieve that goal and the amount of risk we are both able and willing to take in order to achieve that return. Then, and only then, can we build a strategic asset allocation that gives you the highest likelihood of achieving your return objective based on long-term relationships of various assets. While constructing this long-term strategy you must do something that is incredibly difficult: you must completely ignore what is happening in the market today. Don't worry, we will eventually get around to today's environment, but not yet. First we have to look at long-term market relationships and the big picture questions like how much equity exposure should I have long-term, how much international, how much real-estate, and how much in bonds? Only once we have made these decisions can we intelligently look at what is going on today.

Once you know how much equity exposure you want in the long-term, then you can review what is going on today and decide if right now you should be over-weighted, have more exposure than your long-term strategy calls for, or underweighted. If you are not sure, then go back to your long-term strategy. This structure gives us a framework from which to make rational decisions in an irrational market. We can then control the amount of risk you take by asking one simple question: what happens if we are wrong?

That is the key to controlling risk. It sounds so simple, yet most investors just are not willing to consider the possibility that they could be wrong. It's too painful. Yet if you invest money long enough, you will eventually be wrong, but that doesn't have to be a bad thing. If you consider your mortal nature before pulling the trigger, make sure that the odds are in your favor for being correct and that if you do happen to be wrong then it won't hurt your overall portfolio too badly, than you will be okay in the long-term. This year, the market has been irrational and we, who pride ourselves in making rational decisions, have been wrong about many things, but our performance has still held up. How can that be possible? It is possible because at Iron Capital we heed Mr. Keynes' warning and do all in our power to keep our clients solvent while the market is irrational.

Have a great summer,

Chuck Osborne, *Managing Director* +

The greatest threat to the economy is a possible slowing of consumer spending.

REVIEW *of* ECONOMY

THE FEAR OF INFLATION combined with slow growth has gripped the markets and the economy in the second quarter. This is typical of a mid point in the economic cycle as inflation tends to trail growth. The key is how the Federal Reserve handles the situation. Inflation is now rising at an annual rate of 3.8%, the fastest rise in 11 years. The Fed has continued their attack of raising fed funds interest rates at every meeting and it currently stands at 5.25%. This is beginning to have an impact as GDP growth has slowed from a sizzling 5.6% in the first quarter to an estimated 2.8% in the second quarter. The consensus projection is for the economy to grow at a rate of 2.9% from here to year end and slow further to 2.7% in the first half of next year.

The greatest threat to the economy is a possible slowing of consumer spending. Consumers face record levels of debt, rising energy cost, and downward pressure on their home values, which had been their savior over the last several years. However, this should be kept in perspective. We are speaking of slowing growth not an actual recession. Corporate profits remain strong, with the consensus calling for a 14.5% rise in 2006 then slowing next year. We believe the consensus may be a little high but the outlook is still quite good, and while job growth has slowed, the economy added 325,000 new jobs in the second quarter and unemployment remains very low at 4.6%. Hourly wages in May were up 3.9% over last year, the largest annual rise since June 2001.

The global economy looks much stronger than the US alone. A resurging Japan has helped greatly with the Japanese economy expected to grow at a rate of 3.1% which would be a blistering pace for Japan. Asia as a whole is expected to grow at 6.7% rate this year led by India and China. +

MARKET *forecast*

We started the year with a forecast of a 7-9% gain on the S&P 500 which would mean a 6% increase from this point. We are staying with that prediction. We expect the market to remain volatile with little real movement. Equities remain more attractive than fixed income with interest rates continuing to rise.

Within the domestic equity market, we believe large cap stocks are the most attractive. Mega cap stocks are selling at a discount to the rest of the market based on trailing and expected P/E and Price/Cash Flow ratios. Small and mid-cap stocks have significantly outperformed for the last 5 years and are becoming less attractive from a fundamental standpoint and are now under short-term selling pressure. Growth stocks look especially attractive right now, although the market momentum is still favoring Value.

Foreign equities are likely to continue their out-performance of domestic equities. Based on traditional portfolio characteristics such as P/E, P/CF, Price/Book Value ratios, foreign developed markets appear attractively priced. Valuations on domestic companies already reflect the competitive nature of U.S. firms. Foreign valuations reflect the regulatory and institutional challenges faced by firms domiciled in less business friendly countries. As many of these foreign countries become more free-market oriented, the productivity and profit growth potential could be substantial. In addition, rising interest rates in Japan and Europe, along with the large U.S. balance of payment deficit, are likely to put downward pressure on the dollar, which should enhance the dollar returns on foreign investments. We believe developed markets are more attractive than emerging markets for the intermediate term.

We believe the Fed is near the end of their tightening cycle, which should bring some relief to the bond markets. However, we do not see interest rates actually dropping anytime soon, with real rates still being historically low. We continue to expect a current yield return from fixed income with little capital gain or loss from interest rate movement. +

REVIEW *of* MARKETS

MARKETS CORRECTED in the second quarter and after living through lots of volatility we are left with modest gains for the year. The S&P 500 was down 1.44% for the quarter which leaves it up 2.71% for the year. Small stocks fared the worst, correcting from a huge run in the first quarter. The Russell 2000 index was down 5.02% for the quarter but remains up 8.21% for the year. Value outperformed Growth with the Russell 1000 Value index, which represents large cap value stocks, being the only major domestic benchmark to post a positive return for the quarter, up 0.59%.

The fed raised interest rates two more times in the quarter leaving the fed funds rate at 5.25% and long-term rates rose from 4.85% to 5.13%. The Yield curve remains downward sloping, indicating that the market expects short term rates to be lower in the future. The rising rates caused the Lehman Brothers US Aggregate Bond Index to be slightly down for the quarter, 0.08% and down for the year 0.72%. High Yield bonds remained positive with the Merrill Lynch High Yield Master Index up 0.15% for the quarter and up 4.65% for the year.

International stocks corrected during the quarter but then rebounded to post a modest gain. The MSCI EAFE index, a proxy for developed international equity markets, rose 0.94%, and is up 10.5% for the year. European stocks climbed 11.00% and Japanese stocks were up 6.82%. Foreign emerging markets, as measured by the Dow Jones Emerging Markets Index, were down 3.3% for the quarter and remain up 9.02% for the year.

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