

Market Outlook

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On Icarus' Wings

The continued evolution of the credit bubble has progressed from homebuyers to banks, and now, to Greece and southern Europe. Despite the pledge of € 750 billion in stabilization funds for the European currency union by the IMF and European Central Bank, markets are retrenching worldwide as risk fears rise again. Investors are understandably skeptical of the ability of the most flagrant borrowers, Portugal, Ireland, Italy, Greece, and Spain (the PIIGS), to reign in their profligate ways. Greece's promises sound particularly hard to keep given that for years they purposely hid their precarious financial state from their Euro partners.

None of this happened by accident, and there have been plenty of warnings sounded by very bright and influential people, yet the overborrowing continued with its inevitable consequences. How can what seems so obvious now have been so roundly ignored even when the risks were obvious? Ironically, part of the answer may be derived from one of the most famous Greek myths, Icarus and Daedalus.

According to legend, Daedalus and his son, Icarus, had been imprisoned in the Labyrinth, home of the half-man, half-bull Minotaur. To escape, the great craftsman Daedalus fashioned two pairs of wings out of wax and feathers for himself and his son. Icarus was warned not to fly too close to the sun, nor too close to the sea. Overcome with the exhilaration that flying gave him, Icarus soared too high, where the intense sun melted the wax. Flapping his arms helplessly, Icarus met his demise in the area which bears his name, the Icarian Sea, near Icaria, an island southwest of Samos.

As with many Greek myths, the concept of *hubris* is an underlying theme in the Icarus story. Feeling invincible, Icarus defies his father's warnings, only to meet a sticky end. In modern usage, *hubris* denotes overconfident pride and arrogance; it is often associated with a lack of humility, not always with the lack of knowledge. The proverb "pride goes before a fall" is thought to sum up the modern definition of *hubris*. It is also referred to as "pride that blinds", as it often causes someone accused of *hubris* to act in foolish ways that belie common sense.

We can find many examples of companies and economic players that have flown "on Icarus' wings." Despite large and obvious risks, they could not help but make, in retrospect, the worst possible decisions for themselves.

Why weren't these risks obvious to the managers at the time? In the case of Greece, lavish social spending, comfy retirement packages, a bloated government payroll and widespread tax evasion were clearly unsustainable. Yet the imbalances grew until borrowing capacity was exhausted, and lenders began to demand their payments. In Greece, the decision to hide their debt could never have come to a happy end, yet the game was played in the face of all logic to the contrary.

The bonuses paid out at big banks and Wall Street investment houses seemed to be the peak of hubris in modern finance, as "too big to fail" exemplified their attitudes as well as their balance sheets. The disconnect between the perceived worth of investment bankers and their systematic destruction of shareholder value was obvious to everyone except the finance insiders. They still persist in justifying their high salaries even when the implosion of the derivatives boom exposed the flaws in their "management."



At Goldman Sachs, evidence is increasing that the structure of some late-bull-market derivatives deals were assembled by one Goldman client and designed with odds stacked against another Goldman client. This has led the SEC to bring charges against Wall Street's biggest

firm. What sort of rationalization led to Goldman's trading against their own clients' best interests, a situation that would have been unheard of thirty years ago? Simply put, Goldman felt that as "masters of the universe" they could do no wrong.

Similarly, what about the hubris of Alan Greenspan's Fed? Idolized and dubbed the "Maestro" for his deft handling of the financial crises of the late 1980s and 1990s, he came to believe the Federal Reserve had cracked the code of high growth, low inflation, and high employment. Unfortunately, we see now that by keeping interest rates much lower for much longer than they should have, the Fed fed the credit bubble on a steady diet of cheap money, even as sub-prime lending boomed and lending standards fell to a bare minimum. Greenspan, too, flew on Icarus' wings, blind to the obvious consequences of easy credit.

The number of additional examples we can cite make clear that *hubris* is a human trait not easily overcome. How, at least when it comes to investing, can we avoid poor decision-making as a result?

The first is to have a firm understanding of crowd psychology. Far from making the markets more rational, the computerization of Wall Street has exacerbated the shifts in crowd sentiment. Sentiment shifts more quickly today, and seems to become more

polarized at the extremes. Observing the behavior of investors can provide important insights into the degree of euphoria or despair they are feeling, and thereby help control our own emotions. Moreover, keeping one's antenna tuned to rising arrogance among CEOs is essential to avoid getting drawn into the investment trap of believing "form" equals "substance."

Second, understanding fundamental analysis is key to being able to discriminate in favor of companies that are financially strong, profitable, and have a strong market for their goods and services. Fundamental analysis is not as widely practiced as before with the rise of packaged products such as mutual funds and Exchange Traded Funds (ETFs), asset allocation programs and the shifting role of brokers from giving advice to gathering assets (to be managed by some third party). Moreover, fundamental analysis today seems to be overly focused on earnings per share, and whether management "beat" Wall Street's earnings guess. Low debt and high return on capital are two factors that are often ignored, yet can provide valuable clues about whether a company can survive today's economic and financial stresses. Long-term investing requires a solid fundamental foundation in order to recognize when things are "too good to be true."

Finally, one must be able to see the big picture. Long-term point-and-figure charts offer the best visual aid to investors looking to control risk and avoid major down trends. These charts have the enviable feature of dampening much of the "noise" associated with stock price movement. What emerges from them is a much clearer answer to the investor's most pressing question: is my security trending up or down? The insanity of today's obsession with high frequency trading, where positions are held for perhaps seconds, and hundreds of trades are done daily, is testament to the hubris of gunslinging hedge funds. They believe speed and brief holding periods can overcome the risks of the market, which the "Flash Crash" of May 6 clearly proved wrong. Using long-term charts allows investors to keep their eyes on the ball when others have lost their perspective.

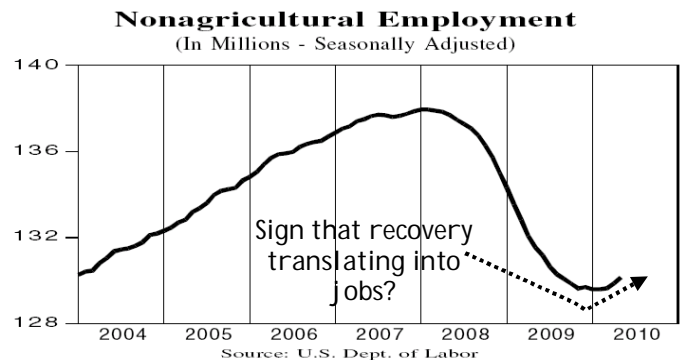
The lesson of Icarus has followed us down throughout the generations because it speaks to one of the most basic human foibles. We can't avoid its recurrence, but we can use common sense tools to avoid falling victim to its powerful and seductive lure.

The Stock Markets

Worries over the European debt crisis, the solvency of lenders to weak Euro countries, and the growth-dampening effects of government spending cuts have combined to send stocks down significantly in May. Add to that the oil spill and saber-rattling on the Korean peninsula, and it's no wonder investors have been scurrying for the exits.

Overlooked in the wave of dismal headlines is the fact that the US and foreign economies are showing clear signs of recovery. Without a doubt, the various stimulus programs put in place helped to soften the recessionary blow and give businesses a

kick-start (especially with the homebuyer tax credit), but recent evidence points to a more self-sustaining business cycle, at least in the US. Retail sales have shown many months of improvement, technology spending is rising, home sales are coming off the mat, and finally a net gain of 290,000 jobs was reported for April. Surprisingly, the recovery has been led by the manufacturing economy, as exports have surged on the back of Asian growth and a weak dollar. International developments can certainly knock the US economy off-balance, but today's environment is much different than the overleveraged, risk-complacent, and, dare I say it, hubristic world of 2007-08.



Another overlooked, though long overdue, positive development is that Europe has been "scared straight." The heavily indebted nations of Europe have begun to translate their fear of suffering Greece's fate into action. Portugal, Ireland, Spain, and Italy have all announced austerity plans that range from raising retirement ages, cutting public spending, and reducing payrolls. The new government in the U.K. has done the same. In contrast to the Greek riots protesting government cutbacks, more polls are suggesting support among voters for governments that have the backbone to face up to the challenge of balancing their books. The mood in Europe may be grim, but people seem to realize that they are living in straitened times. This willingness to adapt to austerity will soften the inevitable economic slowdown, and may perhaps break down some of the worst aspects of Euro economies (e.g. labor market rigidities).

Despite the anxious headlines and dire predictions of pundits, we are finding many stocks (and by extension, funds) that look good. Many are still holding up trends, and have low price/earnings ratios and attractive returns on capital. The correction has had the benefit of exposing the weakest issues, making it easier, in a way, to find those expected to lead the next rally. If the developing economic tailwind described above holds, then we can expect most companies to grow through 2010.

Our clients win or lose based on the securities they hold, not the direction of the economy, and that is where our efforts will be focused. They also provide the best early warning system should the markets be in for tougher sledding than expected. By applying an objective and balanced approach to security selection, keeping an open mind, and avoiding committing ourselves to grand predictions, we hope to avoid the trap of hubris that has ensnared so many in the past.