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In Pursuit of Value

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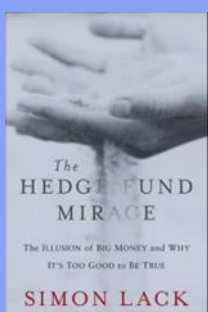
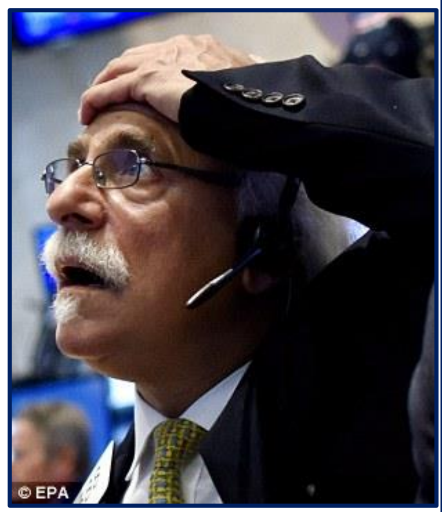


Thinking Fast, And Slow

Market gyrations such as those of the past couple of weeks make a mockery of the Efficient Market Theory (EMT), the Capital Asset Pricing Model and the entire structure of financial theory which holds that markets are reasonably efficient. Prices routinely move more than values, but the University of Chicago Booth School, which is perhaps the spiritual center of this world view, must find the empirical invalidation of their neat models confounding. The frustration of academics worries most people less than the fluctuations of their own portfolios.

A move led by what financial media overwhelmingly dubbed "The Great Fall of China" needs explaining. For years, strong GDP growth in China failed to translate into strong equity returns for investors. There is virtually no link between the two. The most tangible effect of slowing Chinese GDP growth has been lower commodity prices, a well-established trend with which investors in emerging markets and the energy sector are painfully familiar. The collapse in Chinese equities looks to us like a crisis for many over-leveraged Chinese speculators, but not something that ought to impact U.S. GDP. Once again, equity markets have reflected a far sharper change in valuations than seems warranted.



What the f…?

Behavioral Finance and the EMT offer competing structures to explain investor behavior. Richard Thaler in *Misbehaving: The Making of Behavioral Economics* dubs the people who live in the world described by EMT as "econs". These are emotionless agents who have smooth utility curves, never gamble (because of its negative expected outcome) and are always rational. EMT fails to explain the market gyrations of August because it is built on a proliferation of econs as market participants, whereas econs inconveniently don't exist (perhaps outside of Chicago's business school).

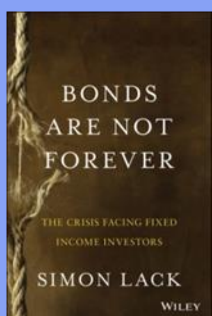
Behavioral Finance offers a coherent structure of markets that can accommodate outcomes when things go haywire. Real people do exhibit loss aversion (a willingness to gamble to avoid a loss even with poor odds) and other irrational, emotionally driven behaviors. Daniel Kahneman's 2013 book, *Thinking Fast, and Slow*, identifies two systems within the brain that govern decision making. They're not physiological systems that exist in discrete areas of the human brain, they're decision-making processes that are identified by the outcomes they create. These Fast and Slow systems (Kahneman labels them 1 and 2) sometimes work together and sometimes are in conflict. The Fast system is intuitive. It makes snap judgments based on feel and emotion. It has biases, because these allow faster decisions. It is lazy, because reaching speedy conclusions doesn't require much effort.

The Slow system is analytical. It gathers information and makes judgments based on facts and experience. It is intelligent. Sometimes the Fast and Slow systems agree, albeit reaching their conclusions by a different route. Sometimes they're in conflict. Years ago my college-age sister greeted an Asian student she met by assuming he was a computer science major (her Fast system), before her Slow system identified the political incorrectness of this and apologized, conceding the possibility of a love of Liberal Arts (of course her Fast system was correct).

Investing is a Slow system activity. But sometimes the Fast system takes over, and when that happens carefully considered long term strategies are ditched in favor of immediate gratification or pain-reduction. Very occasionally, the Fast system can be superior (such as reacting following an earnings release) but most of the time it will be worse and often at severe conflict with the Slow system. The simple idea of Buy Low/Sell High represents an effort by the Slow system to over-rule the Fast one and invest in cheap securities when the Fast system wants to run. Just consider your own mindset when you're contemplating a long term investment versus your feelings when you watch what you own collapsing. Successful investing requires organizing your finances so that your Slow system is always the master of your Fast one.

Financial advisors sometimes call this "hand-holding". One advisor I know describes the most important part of his job as preventing his clients from acting impulsively and selling during a sharp market fall. In effect, he's trying to get his clients' Slow systems to dominate, at a time when the lazy Fast system just wants to hit the sell button. Broadcast media that covers Finance (such as CNBC) speaks to the Fast system, because theirs is a world of sound bites. Print media can do both but is more aligned with the Slow system. You find your investments by reading, and at some point TV will make you want to sell them.

SL Advisors, LLC focuses on investment strategies that provide income without relying on fixed income securities.

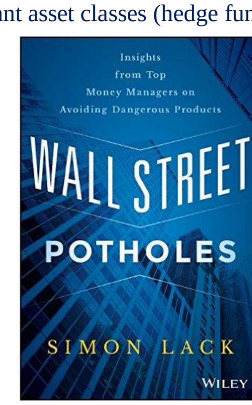


When MLP yields moved up through 7% and briefly exceeded 8% as prices fell, investors whose Slow system dominates were buying from investors whose Fast system had (hopefully temporarily) taken charge of their decision making. A wealth transfer took place from Fast to Slow. EMT maintains that "non-econs", who are by definition irrational, will over time be bankrupted by the relentlessly rational econs who will exploit their investing mistakes and gradually own all the capital. Human investors, who are the kind we care about, can be Fast or Slow dominant and can move between the two.

As a money manager, we want Slow system clients. We try and identify like-minded people before they become clients, and we only speak to their Slow system. Happily, the dialogue we've had with clients in recent weeks as well as their actions confirm that we have an alignment of systems as well as an alignment of interests (i.e. we are heavily invested alongside our clients).

Wall Street Potholes

My upcoming book is a collaboration with four like-minded financial services colleagues. Achieving good outcomes for investors need not be limited to the investment strategies we deploy. *The Hedge Fund Mirage* and *Bonds Are Not Forever* both set out to inform investors with the hope that they would make better decisions. They highlighted problems with two important asset classes (hedge funds and bonds) and showed why future returns were likely to be disappointing. Subsequent events provided support to the views therein.



Wall Street Potholes doesn't target an asset class but instead exposes certain investment products that are primarily designed to create fees for the broker rather than wealth for the client. Regular readers will already be familiar with my thoughts on non-traded REITs, a nasty little product that truly should not exist. There is plenty of additional material, and in the belief that sunlight is the best disinfectant my co-authors and I shine light where it's sorely needed. The book will be released in November. Clients will each receive a complimentary signed copy.