October 2012

SIMMONS Street NEWSLETTER

OPENING REMARKS

MANY POSITIVES DESPITE THE MANY NEGATIVES

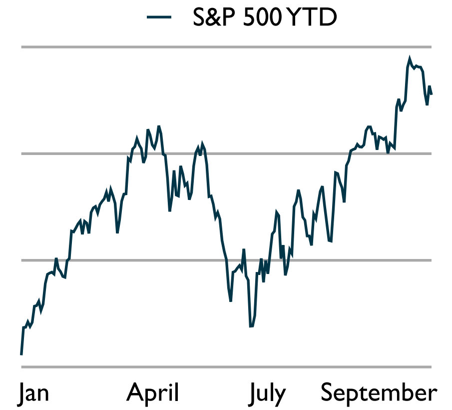
THE COCKTAIL PARTY THEORY

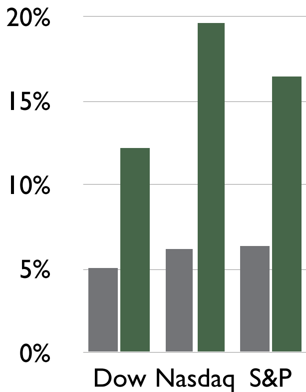
IN SUMMARY

The Cocktail Party Theory

Special Announcement

Simmons Asset Management is delighted to announce the addition of yet another resource that will keep your dollars growing. We are introducing a new service titled the Simmons Wealth Advisory. This free service will provide you timely insight into the financial markets, outline investment strategies and recap the most recent economic activities resulting in improved overall awareness. As always, we appreciate your feedback and welcome any suggestions you have in order to make this service more valuable for you. If you would like to receive the Simmons Wealth Advisory, please let us know.





Opening Remarks

Warren Buffett's mentor, Benjamin Graham, once said, "The investor's chief problem—and even his worst enemy—is likely to be himself." Our intention with this issue is to illustrate why the stock market is, and will continue to be, a healthy and strong source for your dollars, despite the overall negative outlook. The major driving factor that seems to be directly affecting our outlook is nothing more than our own fatigue. Investors are tired and worn out from the day-to-day market volatility and plentiful negative financial news. People honestly want a quieter arena. Remember the good 'ole days when our biggest worry was impeaching presidents over indiscretions?

Throughout my career, I have seen investors choose one of three different routes for their investments. First, they sell them altogether during adverse conditions. Second, they overcompensate or change their investment style, thus exasperating the problem. Finally, a third group quits looking at the market entirely, stops opening their statements and continues on their way as if they have no control.

In hindsight, it's obvious that the first two sets of groups are making a decision that will adversely affect their balances, but what about the third? Ironically, the latter group tends to outperform the rest by a tremendously large margin in almost every instance. By not looking at the markets or negative news that goes along with it, they are also not drawn into the same consequences that force investors to make catastrophic mistakes. They are not as tired as everyone else because they simply aren't exposed to it. As a result, while everyone else fumbles to enormous losses, they, like the tortoise, continue patiently down the road to financial freedom.

This is not to say you don't have a right to be exhausted or that you should have a thoughtless investment strategy. What I am saying is that once you have a well thought out, long-term investment strategy, it should not be modified in any way—especially in the face of exhaustion and despair.

In this issue, we will briefly point out a few positive signs that will hopefully alleviate some of your fatigue and keep you in the game. Sitting tight and not ducking out early will pay off!

Market Insight

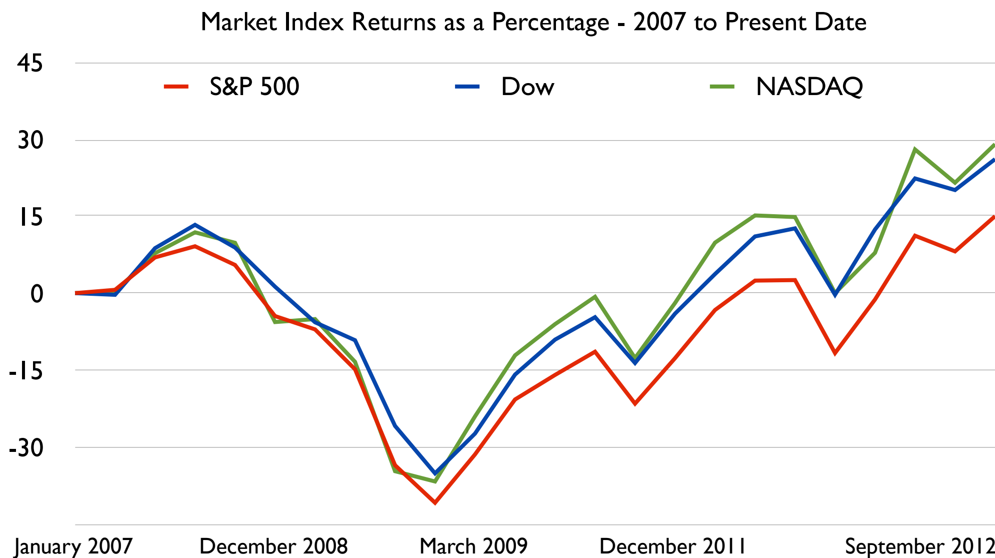
As the markets continued to post positive returns this quarter, it was anything but straight. To name just a few negative aspects; net equity fund flows are negative, consumer confidence is at near decade lows, and the 10-year Treasury note yield has progressively fallen to record depths.

Bank deposits have continued to grow to near $10 trillion, and it is near certain that the real return of those deposits will be less than zero well into the foreseeable future. The Federal Open Market Committee announced in September that it will undertake a third round of quantitative easing by purchasing mortgage-backed securities at a pace of $40 billion per month until labor markets improve substantially.

It cannot be rationally argued that these actions are anything but inflationary and in the long run will erode the purchasing power of cash. Indeed the dollar cratered in value in September, and, since May, gold has rallied as high as 1780. These are extremely negative signals for the owners of cash. Equities have an enormous amount of upside potential, especially as the holders of cash and bonds capitulate over the next several years.

Jim Paulsen recently suggested investors might want to think about the possible effect on equity markets of a rather different sort of perfect storm in 2013, such as a revived China, a re-accelerating U.S. and a calmer, quieter Europe. The real value of cash going forward has been significantly impeached by the central bank actions of the past month. The drawing realization determines that bonds are far from riskless, and the ultimate safety, in the long run, lies not in the form of bonded debt, but in the patient ownership of diversified equity portfolios.

Moreover, net equity fund flow, the value of money moving in and out of the stock market, is negative. When net flows into equities are positive, it is a sure sign that confidence is high among investors. Conversely, when net flows are negative, the market pessimism tends to be very high. Michael Rawson with Morningstar wrote in a recent research report that September "represents the 17th consecutive month of outflows from U.S.



stock funds and further evidence of investors' preference for the perceived safety of fixed income (and cash) over equities. Rather than chasing returns, investors have largely ignored the equity market's rally. The S&P 500 gained 16.4% through the first three quarters of 2012, yet $83 billion of investor capital, or 3% of beginning assets, has left U.S. stock funds."

Consumer Confidence indicates, to no surprise, investor sentiment has been slashed nearly in half over the past 12 years. On the bright side, the preliminary October reading of consumer sentiment from the University of Michigan was much better than expected — up about five points from the month before, marking the highest level since September 2007.

The rate of the 10-year Treasury note yield index has steadily declined since 1990 and essentially has nowhere else to go but up. When this occurs, a new cycle will begin reversing the downward trend that will spell almost certain misfortune for bond investors. As these rates increase, the values of bonds and the dollars invested in them will decrease.

From the lows in 2009, the S&P 500 Index has more than doubled, despite all of the negative data. Many economic indicators, such as consumer confidence, are lagging and only demonstrate how things were, not how things will be in the future. If the broad indexes are able to increase with all the odds stacked against them, how high will they actually go when confidence returns?

Only time will tell how much the market will continue to progress, but I believe the positive returns in spite of net equity fund flows being negative are amazing. This confirms just how strong the market really is as it continues to advance, despite these challenging conditions.

All major declines in equity prices have historically been temporary and given way to a resumption of the enduring positive trend in values. The average intra-year decline in U.S. stock prices has been slightly over 14%. The only practical way an investor could have taken any of these temporary declines and turned them into significant losses has historically been to sell out in panic. Those investors who panicked will be much worse off than if they had just stayed the course.

Cocktail Party Theory

The legendary investor and writer Peter Lynch is regarded as one of the most successful fund managers to date. This is an excerpt from his book, "One Up on Wall Street," where he elaborates on human behavior toward the stock market in terms of cocktail party conversation:

"If the professional economists can't predict economies and professional forecasters can't predict markets, then what chance does the amateur investor have? You know the answer already, which brings me to my own 'cocktail party' theory of market forecasting, developed over the years of standing in the middle of living rooms, near punch bowls, listing to what the nearest ten people said about stocks.

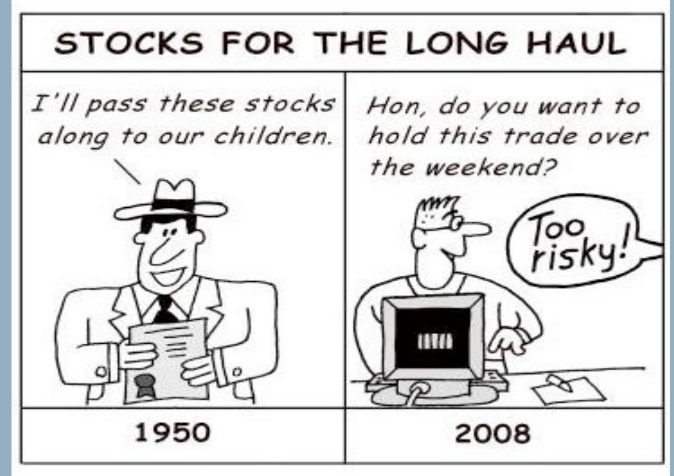
In the first stage of an upward market – one that has been down awhile and that nobody expects to rise again – people aren't talking about stocks. In fact, if they lumber up to ask me what I do for a living, and I answer, 'I manage an equity mutual fund,' they nod politely and wander away. If they don't wander away, then they quickly change the subject to the Celtics game, the upcoming elections, or the weather. Soon they are talking to a nearby dentist about plaque. When ten people would rather talk to a dentist about plaque than to the manager of an equity mutual fund about stocks, it's likely the market is about to turn up.

In stage two, after I've confessed what I do for a living, the new acquaintances linger a bit longer – perhaps long enough to tell me how risky the stock market is – before they move over to talk to the dentist. The cocktail party talk is still more about plaque than about stocks. The market is up 15 percent from stage one, but few are paying attention.

In stage three, with the market up 30 percent from stage one, a crowd of interested parties ignores the dentist and circles around me all evening. A succession of enthusiastic individuals takes me aside to ask what stocks they should buy. Even the dentist is asking me what stocks he should buy. Everybody at the party has put money into one issue or another, and they're all discussing what's happened.

In stage four, once again they're crowded around me – but this time it's to tell me what stocks I should buy. Even the dentist has three or four tips, and in the next few days I look up his recommendations in the newspaper and they've all gone up. When the neighbors tell me what to buy, and then I wish I had taken their advice, it's a sure sign that the market has reached a top and is due for a tumble."

Naturally, we must ask the question: What stage are we in now? The market has been in an upward trend, albeit volatile, for nearly four years. Moreover, it has more than doubled, and no one is even talking about it. The S&P 500 has mustered out a fantastic annualized positive return of over 23% per year, while coincidentally there are immeasurable amounts of people who still view the stock market as an evil, dark place. As I take into consideration the 1) very low investor sentiment 2) premium bond values 3) record low interest rates 4) historical negative net fund flows out of equity funds and 5) enormous levels of cash on the sidelines, it seems evident the market is far away from topping out. Even more, as corporations are posting exceptional fundamental returns, I find it bizarre that there are not herds of people rushing out to purchase equity investments. Equities are naturally climbing a wall of worry, as they have throughout time, and most people won't join the party until it's too late.



Peter Lynch's "Cocktail Party Theory" shows the irony and approach that most investors take. As a financial advisor and money manager, I can speak with certainty that most individuals would currently much rather discuss plaque than the natural appreciation of the investing markets. But experience has taught us that taking a contrarian view that is opposite of the majority is typically the one that pays off big.

In Summary

I am quite often asked my opinion regarding the European crisis, domestic politics and any and all other economic and political concerns. My recurring response is that our country continues to be in a natural recovery, and difficult times exist during all natural

"A stock market decline is as routine as a January blizzard in Colorado. If you're prepared, it can't hurt you. A decline is a great opportunity to pick up the bargains left behind by investors who are fleeing the storm in panic." -Peter Lynch

"Most investors want to do today what they should have done yesterday." *-Larry Summers*

recoveries. Just as someone recovers from an injury, there may be progress each day, and other times it may be weeks before seeing improvement. Most important is the healing that takes place over the long-term despite any temporary setbacks. We know the impossibility of someone waking up and being completely healed without a period of rehabilitation and need to apply this same understanding to our views on the economy and our markets.

People tend to use the difficult issues during recoveries as a reason not to invest or a motive to get out of the market altogether. One person may dwell on the European debt crisis, while another obsesses solely over Iran and Israel and a third discounts both those issues, fixating on the upcoming presidential election. I choose to look at the big picture. The world is a scary place these days, but it's actually been pretty scary at many other times throughout history and experienced significant growth all the while.

From the market low in July 1932 through FDR's re-election in November 1936, the equity markets grew three and a half times, as The Great Depression developed. During the market collapse in 1974 to 2000, there was fantastic growth. At an annualized return of over 12% per year, an investment of $10,000 in 1974 would have been worth nearly $200,000 25 years later.

Further, the Asian financial crisis beginning in July 1997 was a period of financial distress that gripped much of Asia. It also raised fears of a worldwide, global economic meltdown, which never happened. This occurred at the beginning of one of the biggest market up-moves in history.

The market has more than doubled since 2009, but the general public fears equities even more now than it did during the lows in 2008-2009. Somehow, people think the economy is presently even closer to collapse, and the financial system is even more corrupt.

Are you seeing a pattern here? Throughout history, the markets have made significant progress, especially during times when the economy is in trouble and the general public is in distress.

The lesson here is that many people miss out on prosperous periods because they are obsessing over the bad news. Investors think they are being smart by tiptoeing into the water and not plunging in until after everything feels comfortable. But, by then, it's too late.

Harry Truman said, "The only thing new in the world is the history you do not know." Today, there are many people whose investment strategies are driven by Armageddon scenarios as they have been throughout history. I don't want you to be one of them. It is my goal to keep you from repeating the same mistakes that have adversely affected the majority of investors in the past.

Helping to make you a better investor,

-Mark Simmons

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