

Invest Like a Fox...

Not Like a Hedgehog

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Foxes vs. Hedgehogs

**“The fox knows many things,
but the hedgehog knows one
big thing.”**

Archilochus, 7th century BCE

From Isaiah Berlin

Foxes Are...

- **Skeptical of big, central principles**
- **Wary of simple historical analogies**
- **Less likely to be swept away in their own rhetoric**
- **Worried about judging the past too harshly**

Foxes...

- **See more value in keeping passions under wraps**
- **Make efforts to integrate conflicting beliefs, theories, and observations**

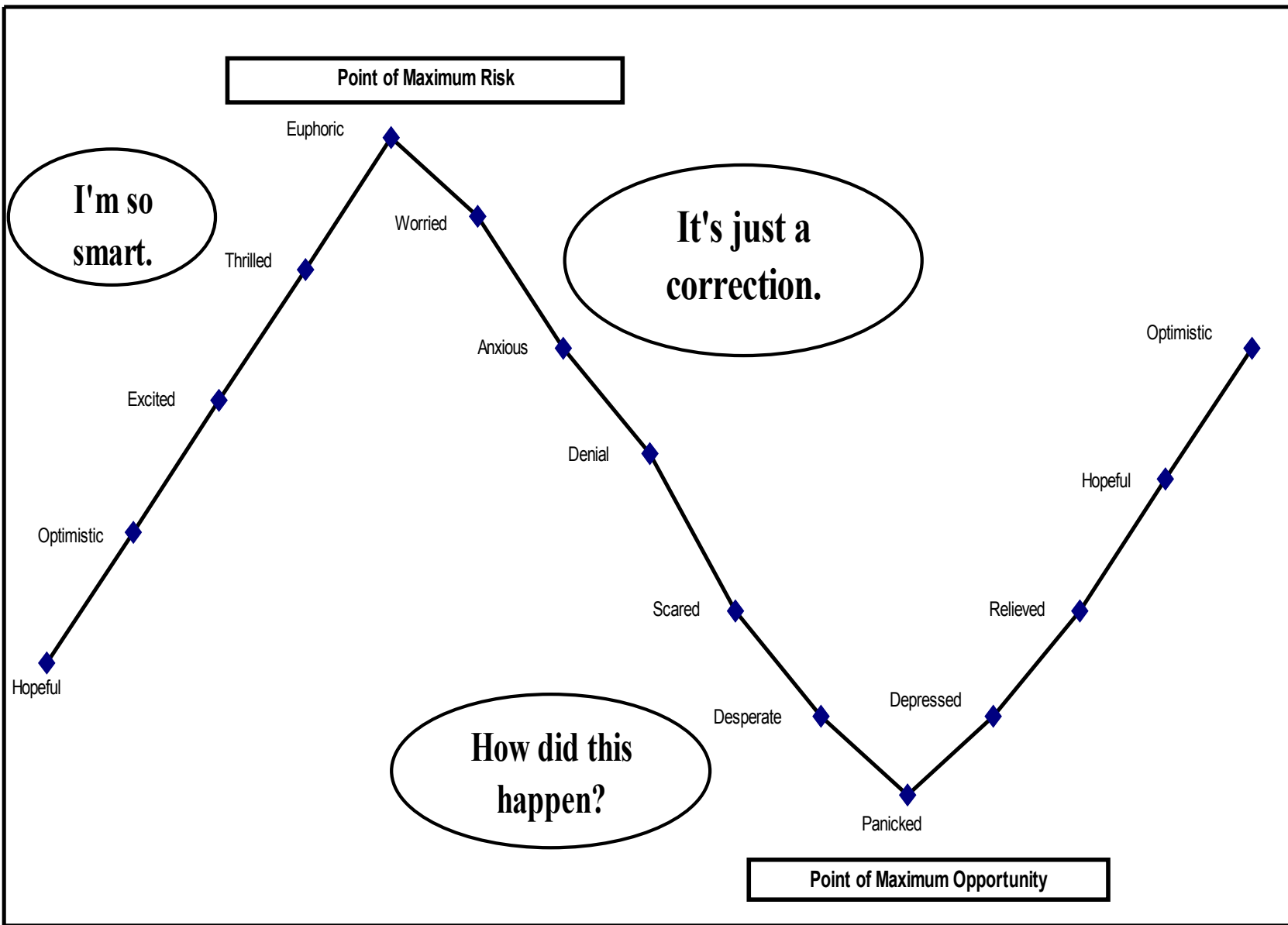
**Hedgehogs Always
Believe in:**

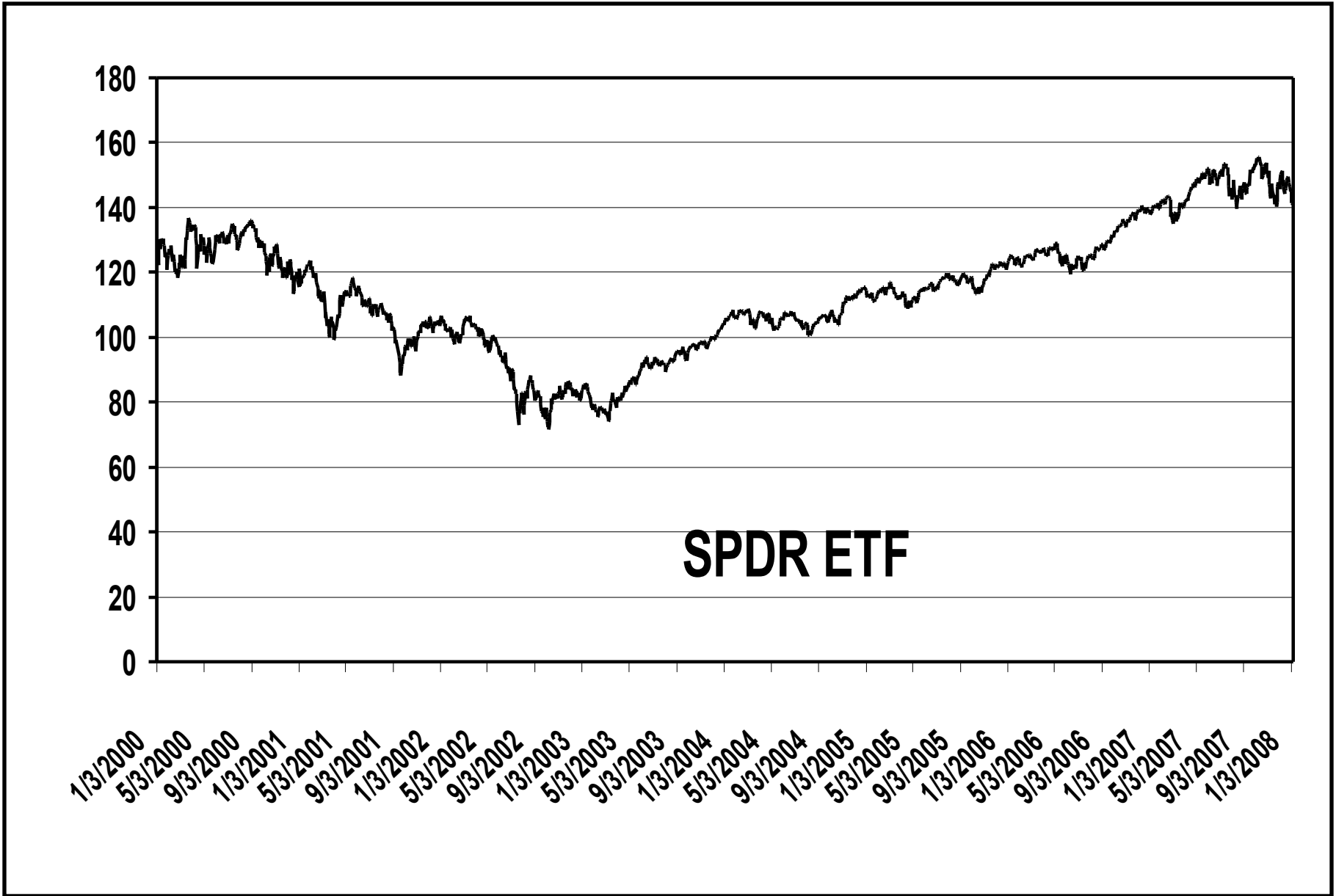
**The Pursuit of the
ONE BIG THING**

Hedgehogs Always Believe:

**The most dangerous
words in the English
language are:**

“It’s different this time.”





SPDR ETF

Questions Hedgehogs Cannot Answer

- Why are prices of investments more volatile than fundamentals?**
- Why do stock prices change without a change in fundamentals?**
- Why does the equity risk premium exist?**

Reasons Questions Are Not Answered

- Returns in shorter periods differ from long-term average returns**
- Correlations and volatility change**
- Volatility is not risk to most investors**
- Long-term bull and bear markets are not explained**

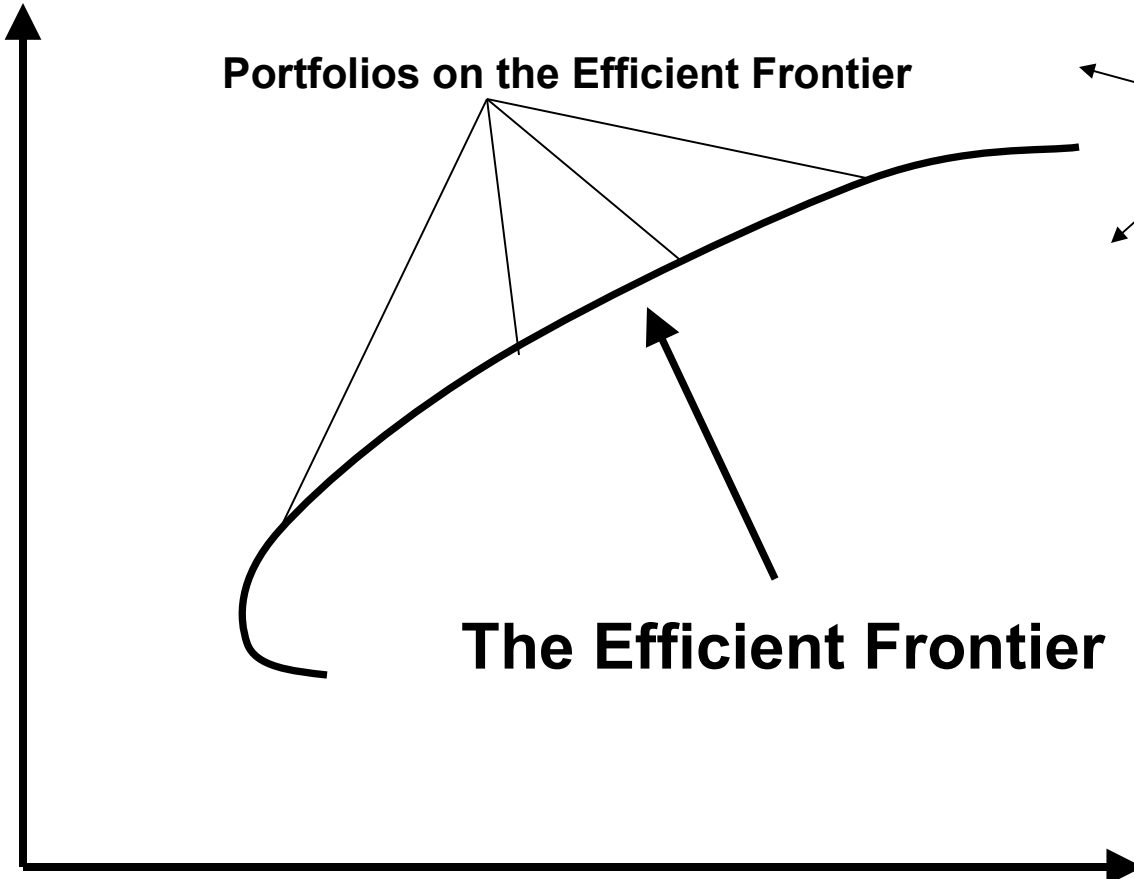
Return

Portfolios on the Efficient Frontier

Areas of Non-Efficient Portfolios

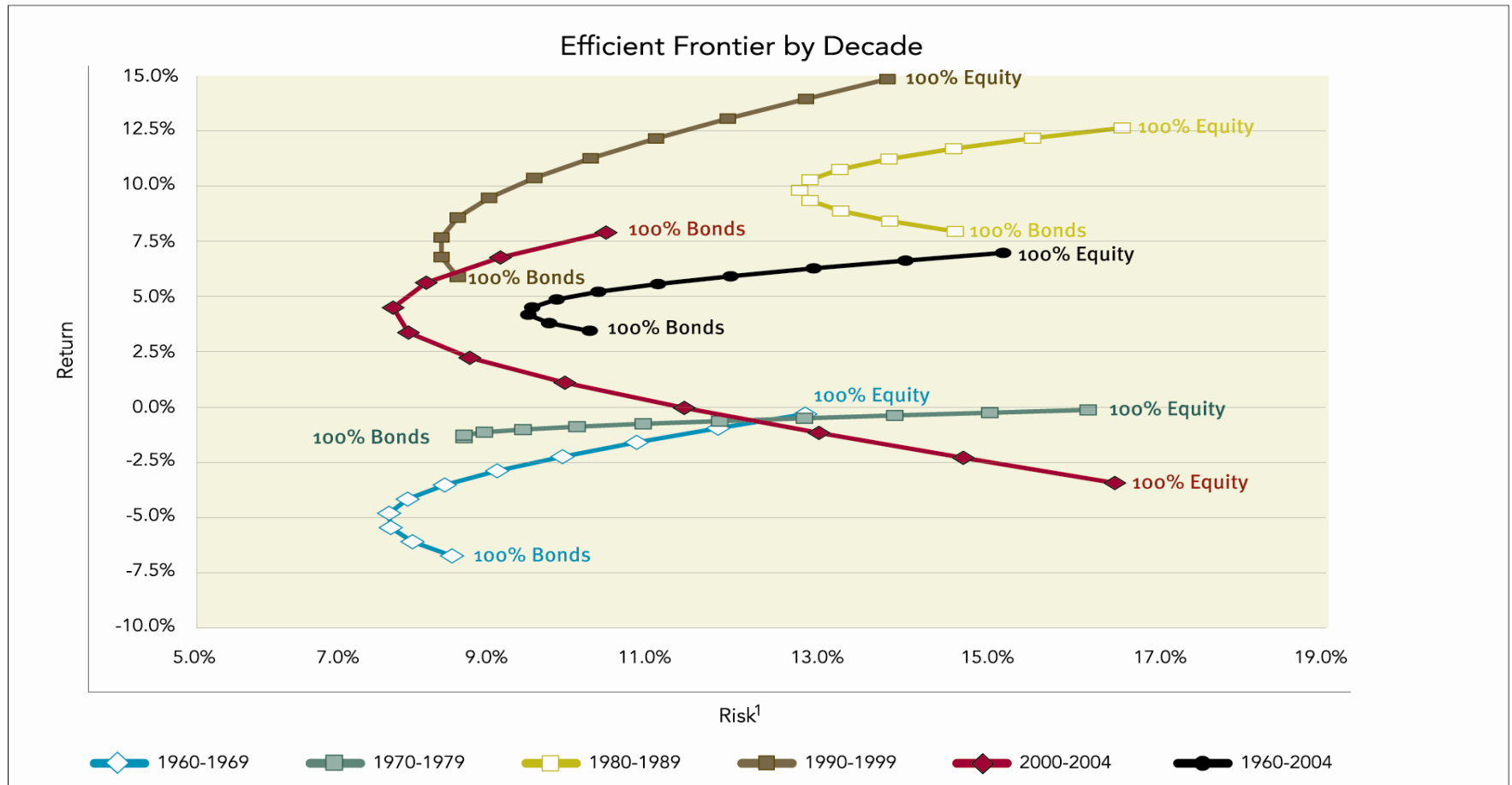
The Efficient Frontier

Risk



Correlations Change

THE LOCATION OF THE EFFICIENT FRONTIER CHANGES OVER TIME



Modern Portfolio Theory

- Risk is as important as return
- Risk of a portfolio is more important than risk of assets
- True diversification reduces risk
- Forecasting is essential to risk reduction and efficiency

What Foxes Believe

- **Markets are not always efficient and rational. They are dynamic.**
- **Investors make mistakes.**
- **Endogenous risk is significant.**
- **Markets can reach extreme valuations.**
- **Investors must act on forecasts.**

Investing as Risk Management

- **MPT says risk as important as returns**
- **Make forecasts**
- **Consider probability of error**
- **Reduce or eliminate unwanted risks**
- **Contingency plans**
- **Monitor and adjust**

Relative Returns vs. Absolute Returns

- Traditional strategy measures against index**
- Should measure against probability of achieving goals**
- Return pattern different from indexes, not dependent on them**

What To Do Now

- **Investors should seek:**
 - **Absolute returns, more predictable returns**
 - **Reduced risk, volatility**
 - **Low correlation with major market indexes—True Diversification**

Ways to Manage Risk

- **Add asset classes**
- **Rebalance more frequently**
- **Use value managers**
- **Manage asset allocation**
- **Use unconventional strategies**
- **All-Weather Strategy**
- **Hedge or use hedge funds**

Indicators That Have Failed

- **Dividend yield**
- **Price to book value**
- **Price-earnings ratio**
- ***q* ratio**
- **Technical analysis**
- **Extra-market factors**

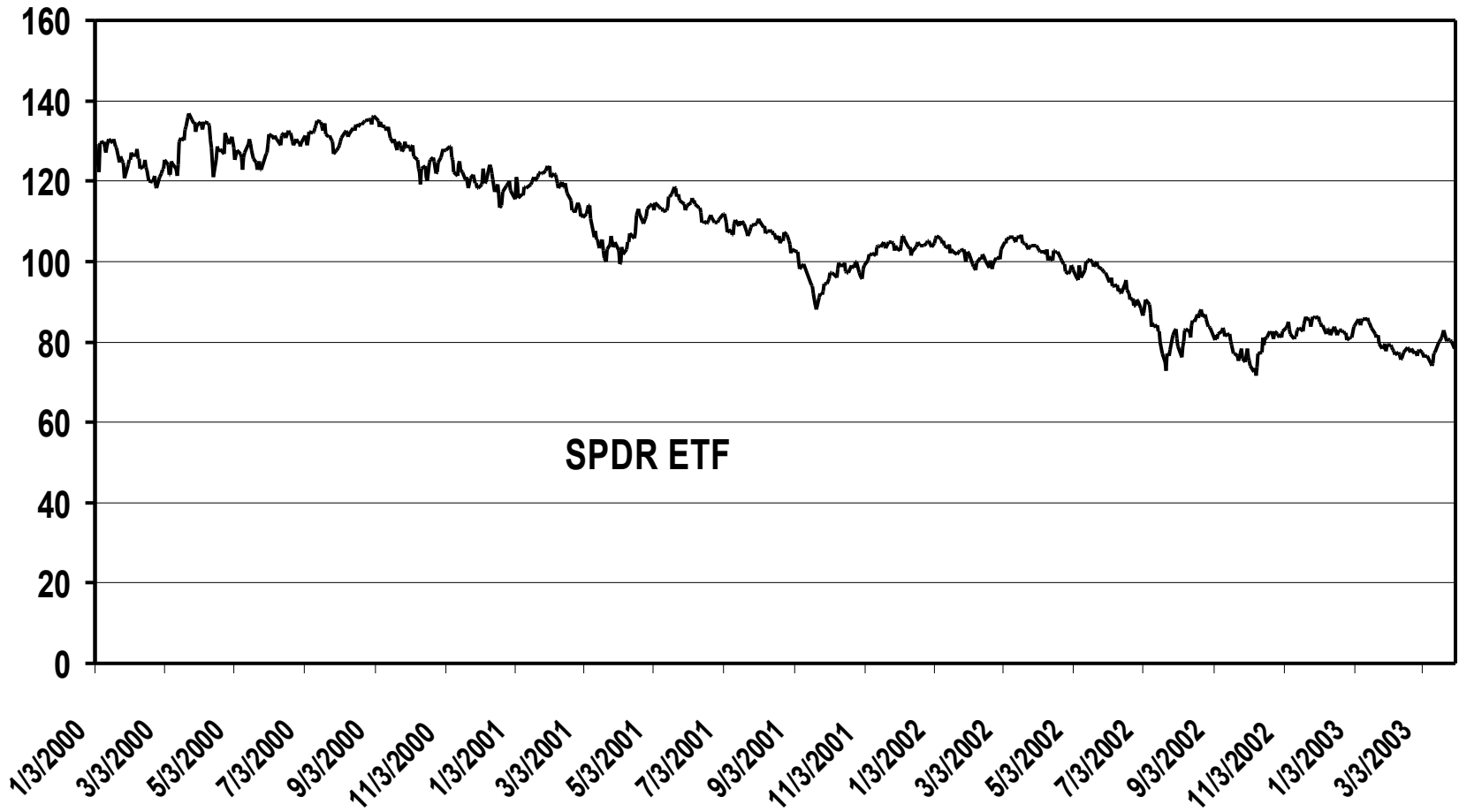
What Not to Do—Why Indicators Fail

- **Random events \neq cause and effect**
- **Too many variables**
- **Fat tails: The unexpected happens**
- **End points affect results**
- **Correlation never is 100%**
- **Markets are dynamic**
- **Turning points obvious only in hindsight**

Where Are We Now?

- **Unique Financial Markets:**
 - **Interest rates already low**
 - **Credit and borrowing crisis**
 - **Global growth supporting U.S.**
 - **Housing problems isolated?**
 - **Inflation still not contained**

2001 or 2002?



Time to Bottom Fish?

- Weakening labor market
- Soft mortgage applications
- Record profit margins
- 21 of 27 measures turned negative
- Export growth is slowing
- Signs of weakness in Europe
- Gradual deterioration of economy

Why Disasters Don't Happen

- **Diverse, service-oriented economy**
- **Regulators, investors aware of problem**
- **Globalization, with weak linkages**
- **Sectors not as correlated**
- **Wealth effects are lagged**