Essential Works of Stuart Chaussée

Understanding Risk, Investor Behavior and Surviving Bubbles

Dividend Investing for Income and Growth

Advanced Portfolio Management: Strategies for the Affluent

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Understanding Risk, Investor Behavior and Surviving Bubbles

Contents

Introduction

Good times teach us only bad lessons: that investing is easy, that you know its secrets, and that you needn't worry about risk. The most valuable lessons are learned in tough times.
–Howard Marks

WHEN *ADVANCED PORTFOLIO MANAGEMENT: Strategies for the Affluent* was published in 2002 I felt it was a pretty timely offering. We were in the middle of an Internet/tech bust that brought down major market indices by nearly 50% and the tech-heavy NASDAQ by more than 70% from peak-to-valley. The book earned praise from *Barron's* calling it "one of the best investment books of the year" and "a book aimed mainly at seasoned investors, though it describes complicated issues clearly and simply and gives advice that might be useful to both pros and amateurs." However, when I review my work it is obvious to me how much an additional 13 years of experience managing money has improved my understanding of markets, risk and investor behavior.

In the two new books included in this *Essential Works of Stuart Chaussée*, I will share my thoughts on the following topics in detail: investment risk, investor behavior and psychology, market cycles, bubbles and a complete separate work on investing in dividend growth stocks.

Understanding Risk, Investor Behavior and Surviving Bubbles, covers important topics that will allow you to manage money well during all cycles. This involves adopting a different mindset and the ability to make investment decisions unlike others – in a manner that institutional money manager, Howard Marks, refers to as second-level thinking. The ability to think differently or against the crowd at times, and define and recognize risk, is critical to a lifetime of investment success. You must have the strength and discipline to adhere to your convictions, particularly at market extremes. You also need to have an awareness and understanding of market history and cycles. Last, I offer an in-depth look at bubble mentality, a brief history of the recent U.S. housing market bubble and how to survive and flourish during periods of extreme mispricing.

My second offering is more specific to money management strategies and improves on the structured indexing approach I introduced in *Advanced Portfolio Management: Strategies for the Affluent*. In the low-yield world we live in, I find indexing, structured or traditional, unable to meet the goals of my clients as the income is inadequate and risk control nearly impossible. In *Dividend Investing for Income and Growth*, I will show you how to create, manage and monitor a portfolio of dividend stocks that will give you the cash flow you need to supplement your income and also allow for moderate portfolio growth. This approach is most appropriate for investors nearing retirement or already in retirement. In addition, I believe this investment approach, coupled with an understanding and recognition of risk and cycles, will help you avoid many of the pitfalls that face buy-and-hold investors and hopefully avoid taking unwarranted risks at market extremes. In other words, you will learn to adjust your portfolio and reduce volatility and risk when necessary, particularly during market bubbles, and increase your allocation during bear markets or crashes. The bottom line is to avoid as many investing mistakes as possible and ultimately earn a better

risk-adjusted return than you would with an indexed or more traditional active management approach *and* avoid risk as much as possible when others are ignoring it.

Last, my original work, *Advanced Portfolio Management: Strategies for the Affluent,* is included in this *Essential Works* as I still believe many of the topics are relevant and helpful. I would suggest reading the individual chapters that are of most interest to you and your financial situation. If you are a retiree or nearing retirement you might find the chapters on creating an income stream and portfolio withdrawals in retirement, the most helpful.

Essential Works of Stuart Chaussée is not an investment manual, rather, it is a statement of my investment philosophy that I believe can help keep you on track for a lifetime of successful investing. Hopefully you will find the content thought provoking as it forces you to think in a non-traditional, unconventional and often contrarian manner.

1

Defining and understanding risk

The risk of permanent loss is what we care about most.

TRADITIONAL MEASURES OF RISK, such as standard deviation – the measure of volatility of returns of a particular security – are insufficient and offer little help structuring, managing a portfolio or predicting various outcomes. Still, academicians typically equate risk with volatility. But really, is volatility of returns all that relevant or of interest to most investors? I doubt it. Sure, if you have money saved for a down payment on a house that you are going to purchase in the next year and you invest it in a volatile social media stock and half your money is gone when you need to close escrow – that sort of volatility of returns is certainly relevant and can be defined as risk. But, few investors, if any, have a time frame of a year or even a few years, and quite frankly, I have never had a client ask me about the volatility of an investment or remotely suggest that volatility equals risk.

So, what is a better definition of risk? A better definition must include an understanding of the uncertainty of future returns, and

most importantly, risk of loss and perhaps permanent loss. This is what investors worry about. If we are dealing with an unknowable future, then risk is present in every investment decision we make and it's essential to understand it as best we can. We need to define, recognize and control risk at all times.

We can all agree that risk is something we would prefer to avoid. Most people are indeed averse to risk and will avoid it if possible, but of course, many investors also want the possibility of the higher returns often associated with assuming risk. When considering an investment, investors want to know if the possibility of higher returns is worth the risk of loss. If higher returns were not a part of the deal, why would any rational investor assume risk? It wouldn't make sense. Does the potential return justify the risk? That is the critical question.

When you look at your portfolio statement at the end of the year and you see your investment manager made you 10%, was that a good return? I don't know and neither do you without having a further understanding of the risks taken to achieve the return. And, I'm not talking about the volatility of returns to get there – we already determined that volatility is an insufficient measure and of little interest to most investors. But, what did your advisor invest in to obtain the 10% return? Did he own five stocks and happened to make 10%? Was the return all earned in long-term Treasury bonds and your advisor happened to be lucky as interest rates declined and bond prices surged? Or, was the return earned in poor companies that happened to rise simply because we were in a strong bull market (a rising tide lifts all boats)? Was there any skill involved or just luck? In order to know how your manager has performed it's important to understand how much risk was taken and this will give you an idea as to your risk-adjusted return – return relative to the risk assumed.

It's also important to recognize that, contrary to public opinion, higher risk doesn't necessarily mean higher return. Sure, there should be the possibility of higher returns, but the fact that the higher return isn't certain is actually what makes the investment riskier. It is futile to tell yourself that you need to increase your risk to get a higher return, because the higher return might not materialize. It is the uncertainty of returns that define risk – the risk of loss, and the fact that the distribution of the returns is variable. It is critical to understand that you have the possibility of higher returns, but lower returns too and even permanent loss.

How do we measure risk exactly? I believe risk is subjective and is defined differently by each individual. But, most of us can agree that risk of loss or uncertainty of returns is probably the risk we care about most. But, unfortunately, we can't measure it, or at least not precisely. We can guess what might happen in the future, but it is only an educated guess. So, it's critical to understand the flaws of traditional measures of risk and recognize that risks are often subjective and ultimately it is impossible to define – it is unknowable, as is the future.

So, we have a problem. If the risk of loss cannot be broadly defined, measured, or agreed upon, how do we handle it? How can we make a proper judgment of risk to help manage a portfolio and understand the probability of various outcomes? A good investor can make a judgment based on the stability or dependability of a return. In addition, projected cash flow and an understanding of the relationship between what we define as value and the price we pay can help measure risk.

We can agree that it is impossible to know what the future holds, but we can have an idea as to the range of possible outcomes. If we can have a sense of the future (even if it is largely subjective and a matter of opinion) by studying the past, it does allow us to make an educated guess as to a probable outcome.

There are several keys to defining and understanding risk. Here are a few takeaways that you should get from this brief chapter:

- Risk is mostly a matter of opinion and subjective.
- Risk cannot be precisely measured and return alone says little about the risks assumed.
- It is impossible to know the future and that uncertainty can be defined as risk and the very real possibility of permanent loss of capital.
- Projections made using the past are helpful, but the future may not be like the past, so these projections have limitations.
- Higher risk doesn't necessarily equal higher returns.
- Investors overestimate their ability to measure risk. There is so much we don't know.

2

Recognizing and controlling risk

Take calculated risks. That is quite different from being rash.
-General George Patton

WE'VE NOW ACCEPTED THAT RISK can be defined as the uncertainty of future outcomes and we can agree that risk can also be defined as the possibility of loss. Recognizing risk begins with an understanding of value and knowing when an asset is priced high or low relative to the projected return. This is critical. So, high risk with a low projected return is clearly an acknowledgement of the relationship between value and price and the associated risk.

Risks increase as markets and valuations rise, since the projected and expected returns decline. Quite simply, as a bull market ages and prices rise, investors become more risk-friendly, looking for greater returns, even though history would suggest the opposite will occur. When investors are willing to accept more risk, as a result of perhaps recent positive returns thanks to rising prices, the rational investor should be skeptical of future positive returns continuing at the same pace. And, if you are going to accept risk, don't you want commensurate potential returns for assuming the

risk? So, why would the unemotional, level-headed investor buy more of a stock or asset class as it becomes pricier and the projected returns decline? It doesn't make sense, yet this is how most of the investing public behaves.

When investors have few worries and are complacent, often because returns have been steady and positive (as they have been recently), they develop a tolerance for risk and pay higher prices for assets. During periods of high valuations or bubbles, as price-to-earnings multiples rise, low or even negative projected returns become likely in future years. So, it's critical to recognize when risks are elevated and projected returns become unattractive.

The degree of risk present in the market is determined by the behavior of the participants (buyers and sellers) and if ignored will lead to possibly poor returns and certainly unattractive returns on a risk-adjusted basis. At extremes, greed and the possibility of easy money and profits encourages the herd to pile into investments with little regard for risk, value, or an understanding of the potential consequences of their actions. This is what pushes markets into dangerous bubble territory. It also stems from a belief that the good times will continue indefinitely, and increased risk isn't actually considered increased at the time it is assumed. In other words, the irrational investor doesn't recognize that risks have risen – he or she believes the investment is low-risk and has been conditioned to believe so by the attractive recent returns. So, if it is not really risky, why not buy more?

Increased risk in investing comes from paying a high price for a lower projected return when optimism is rampant and there is little concern for potential loss of capital. Where we stand today, in early 2015, I see many of the same market characteristics and behavior exhibited by investors that I saw at the height of our most recent bubble in real estate and stocks in 2007. Fast

forward eight years and here we are again – we have low levels of skepticism and fear with many participants willing to take on higher risks with little awareness that the projected returns don't warrant the risk assumed. This clearly has the makings of another bubble. Basically one sees few assets that investors are willing to sell, except at premium prices and buyers are increasingly willing to pay higher and higher prices for an asset they were perhaps unwilling to buy at discounted prices a few years ago.

Most investors are unaware that their behavior causes market risk to rise and fall. Certainly risks rise as investors accumulate more assets and the opposite is true if they are unloading assets in a panic (bear-market behavior) – the market actually becomes less risky as future returns look more attractive. The increased confidence of the retail investor and even the "professional" fund manager, should make the deeper thinker worried as projected returns are reduced due to rising prices. And, the opposite is true too. If investors are of the mindset that "I won't buy that at any price, it's too risky," there might be a great opportunity to profit for those who can recognize it. If everyone believes an investment is risky, it probably isn't. In fact, at a depressed price, future returns are probably quite favorable. And, of course, if everyone believes that risk is low and future attractive returns are likely, the more seasoned investor will probably determine the opposite is more likely to occur. In short, what is of utmost importance in understanding the relationship between price, value and risk, is that the price paid for an asset and the projected future returns (attractive or unattractive) will greatly determine the level of risk.

A good investor can control risk, first and foremost, because he or she recognizes it exists and has an understanding as to when it is elevated or low. However, since there are more good years than bad in the stock market, this recognition of risk may only

become apparent in bad years (negative market returns) – that risk control was important and necessary at the time. Risk control in anticipation of a bear market or correction is critical, and the objective of losing less than the market itself and minimizing drawdowns is a worthy pursuit. Or, if possible, to not lose any money would be ideal.

The bottom line is it is an investment manager's job to intelligently assume risk for potential profit, when it makes sense. We can accept risk when the reward is worthwhile. We can never avoid risk altogether, since the future is unknowable, but we can do our best to control it and even welcome it at times. As General George Patton said, *"Take calculated risks. That is quite different from being rash."*

"We've considered every potential risk except the risks of avoiding all risks."

3

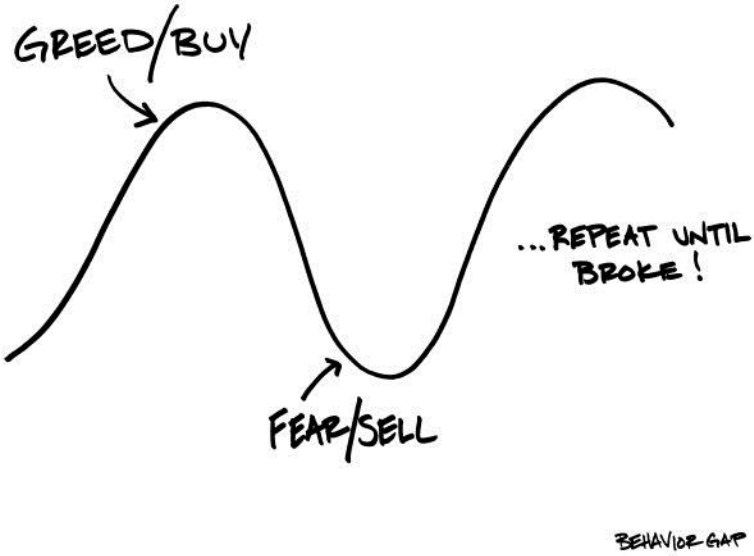
Pendulum theory and market cycles

What the wise man does in the beginning the fool does in the end.

ECONOMIES AND MARKETS are governed by our collective emotions and behavior and as a result are highly cyclical. During my nearly three-decade career I have seen markets move between fear and greed more often than I'd like. Sure, opportunities are presented when it happens, but because of the nature of human beings (investors) and our propensity to act on our fears and greed (with our wallets, so to speak) markets will always be highly volatile and cyclical.

In his excellent work, *The Most Important Thing Illuminated*, investing legend Howard Marks, writes at length about markets swinging like a pendulum between optimism and pessimism – between greed and fear. He warns that if you don't pay attention to where we are in the cycle you can "get killed at the extremes." He couldn't be more spot on.

True, prices and valuations seem to be generally situated in the middle of the pendulum or cycle (not at extremes), and typically on an upward trend, but there are times when the pendulum



swings to one extreme or the other. Investor behavior is such that buyers are either incredibly optimistic and scooping up real estate and stocks with no concern about losing money or, so depressed and skeptical that they question why they ever bought any stock (since all they do is decline) and owning property is a leveraged disaster and a quick way to the poor house.

Because of the nature of human beings and our inclination to not truly be long-term investors (how can you be when a buy-and-hold strategy can lose 30% to 50% at the extremes?), they will act as prices of their holdings drop (usually sell in a panic) and they will also not sit passively as prices rise to dramatic levels – they usually want to buy more since gains are so easy to come by. But, these actions create cycles and swings in the "pendulum" and often quite rapidly. As a result, if one isn't paying attention to the cycle, gains can evaporate quickly and retirements put on hold or derailed when trends reverse.

There are many events and actions (e.g. Central Bank intervention or policy changes) that play a large role in moving

the pendulum around, but it is indeed our behavior as investors that causes volatility and cycles and will also determine the degree of the move in either direction. In good times we tend to be too optimistic about the future, spend freely, leverage up, take vacations, buy stocks and property, save little, and generally live the "good life." However, the markets don't move in a straight line (predictable in their unpredictability) and when sentiment changes, we see the reverse. We worry, panic, dump our stocks and downsize our real estate (if we can sell), try to cut back on our lavish ways and wonder if the good times will ever return. It is indeed a vicious cycle.

If we think back to earlier chapters and the topic of risk, it is precisely our attitude towards risk that moves markets. And, excessive risk-taking or aversion to risk creates both bubbles and the subsequent crashes that have confronted investors throughout history. But remember, both are extreme consequences due to our changing attitude toward risk. If we fear losses, we often miss an opportunity for a purchase at a bargain price. And, if we fear we will miss out on gains (often at the top of a bull market or bubble), we often become paralyzed when markets turn for the worse and sentiment reverses and profits evaporate.

If you look back at any of the recent market cycles (bear and bull) it is easy to characterize the extremes. Here's a brief list of what to look for to help determine where we are in the cycle:

Top of a bull market or bubble:

- No concern about losing money.
- Things will only continue to get better, forever.
- "This time is different."
- Rapidly rising prices of real estate and stocks.

- Recent returns are high and so are expected future returns.
- Overvaluation relative to historical norms.
- Overvaluation compared to reasonable levels.
- Several years into an economic advance and the economy is strong.
- New money and investors drawn in – investors are aggressive.
- Popular media interest.
- Rise in lending.
- Easy money policies – low interest rates.
- Low savings rate.
- Optimism all around – general "feel good" period.
- Owners are happy to hold and reluctant to sell assets.

Bottom of a bear market (recessionary times):

- Negative sentiment.
- Investors are worried about losing money.
- Poor recent returns and poor expectations for future returns.
- Undervaluation based on historical measures – bargains are to be had, but there is a buyer's strike.
- A year or two into a recession or bear market in stocks and/or real estate.

- Media is focused on the negative – poor performance by fund managers and markets.
- Interest rates may be high and lending somewhat tight.
- Owners want out of real estate and stock holdings and will often sell at discounted prices to simply stop the bleeding. Losses are taken.

Investors and investment advisors/managers have a couple options to consider when managing portfolios with regard to market cycles.

1. *Ignore cycles – buy-and-hold*. If we can't predict the future and make good judgments, or we are personally incapable of doing so, one option is to buy-and-hold. We can invest with no consideration for valuations, price, or where we are in the cycle or pendulum. This is known as a buy-and-hold approach. This option, of course, means you have to be willing to watch your portfolio evaporate by perhaps 50% or more as the cycle turns pessimistic and a bear market hits. The average bear market loss in the stock market is approximately 30%, so you would have to be willing to sit through the pain of watching your net worth plummet on occasion for a buy-and-hold strategy to work for you. If your life expectancy and investment time horizon is long enough, you may well live to see the cycle turn yet again higher and simply ride out the painful decline, knowing it will be temporary. Note, "temporary" could be a decade or longer.

2. *Recognize where we are in the cycle and adjust your portfolio accordingly*. This second option, and my preferred approach, is to try to recognize where we are in terms of the pendulum (between fear and greed – pessimism and optimism). If we can have a somewhat realistic assessment of where we are in a bull or bear cycle it seems to make complete sense to act accordingly – increase or decrease risk by adjusting one's allocation.

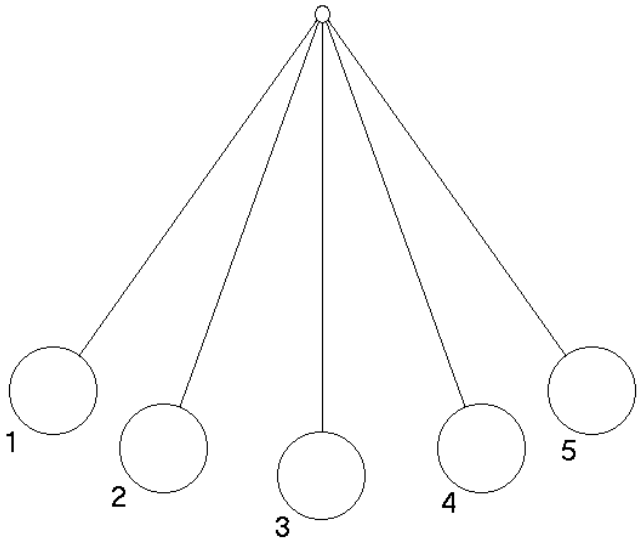
Certainly we cannot know exactly when a trend will reverse, but we should have a pretty good idea when we are getting close to extremes. We can adjust our behavior at those times to not follow the herd off a cliff. The investing public has typically been dead wrong at market peaks and troughs – and most investment managers and advisors too. If you think differently from the herd and recognize cycles and where we are in terms of overpriced vs. underpriced, you will be able to manage your portfolio in a manner that can hopefully save you money (lose less or nothing at all) during bear markets and prosper during bullish times.

If we choose Option 2, how do we guarantee we can act when necessary to either reduce or increase risk? You can't guarantee it, but with some work and understanding of markets you can prepare well. Most investors simply watch the market's ups and downs on any given day with little thought as to why it acts the way it does, where we are in the cycle, and what's going on around them – as far as the behavior of other investors. This is a mistake. It's not rocket science and it's not that difficult to see where we are in a cycle – I'm not suggesting you try to predict the future, rather, try to make an honest assessment of where we are currently and what the appropriate response should be (reduce or increase your allocation to stocks, real estate or bonds). You can make some great allocation decisions based on your present observations. Again, pay particular attention when you feel we are getting to an extreme point in the cycle.

It is dangerous to your financial health if you ignore investor behavior and its ability to push markets to extreme levels. Markets will not do consistently well and stocks and real estate prices will not always be either at lofty or depressed levels. If you do your best to locate and quantify where we are in the cycle, you can both protect capital as we move into high-priced bubble territory and you'll also have some ammunition (having

raised cash as assets move to overpriced levels) to buy assets when your neighbors are panicking and selling at depressed prices. Again, we don't know how far the pendulum will swing in either direction, but we can at least do our best to control risk at extreme valuation levels. One thing is for sure, the pendulum will *always* reverse course, eventually. Humans are highly emotional and subject to greed and fear and that will allow the astute investor an opportunity to capitalize.

Fear-Greed Pendulum



Fear ***Greed***

4

Politics and seasonality

The third year of the presidential cycle is by far the strongest and most compelling year to stay fully invested in stocks.

POLITICS AND THE ELECTION CYCLE can have a huge impact on prices. And, while there are many different theories and beliefs related to how seasonality and various patterns influence stock prices, the one I feel is actually worth paying attention to is the Four-Year Presidential Cycle. The numbers and logic are simply too powerful to ignore. No, history doesn't always repeat itself, but it certainly appears as if it has a tendency to do so during the Presidential Cycle – or at least the data show this to be the case.

Presidential elections have historically had a strong impact on our economy and subsequently on stock prices. In his excellent book titled *The Little Book of Stock Market Cycles*, Jeffrey Hirsch devotes a lengthy chapter on the subject that clearly shows various patterns and returns during a presidential term. Without a doubt, the largest returns have come in the third year of the cycle with the first two years being mediocre and the fourth year also relatively strong. Using data from 1833 to 2011,

Mr. Hirsch found the pre-election year and the election year showed substantial advances, again, particularly the third year. The gains of these two years combined, during 44 political administrations, was over 700%, while the returns of the first two years were less than 300%. The pre-election year was particularly strong, showing a total return of nearly 470%.

The theory behind the clear outperformance of the pre-election year is that an incumbent will do everything in his power to pump up the economy and markets for the voting public. Spending cuts and other potentially unpopular budget considerations are put off in an effort to strengthen the economy as much as possible to capture votes. The Federal Reserve is also typically on board during the period leading up to an election, as easy money policies and low interest rates will generally help garner votes for the party in power.

If you look at the facts, one can see that economic stimulus measures – increases in spending, projects, public benefits, interest rate decreases and lending – will all influence voters, and an administration and the Fed will use these tools to capture votes. So, if an incumbent administration primes the pump, so to speak, leading up to an election, one can assume that difficult, unpopular decisions will be made soon after an election or re-election. This is the theory behind the relatively poor economic and market performance of the first two years of a presidential cycle.

Let's focus for a moment on the third year of the cycle, by far the strongest and most compelling year to stay fully invested in stocks, or at least to one's maximum target allocation. In reviewing data since 1932, well-respected institutional money manager, Jeremy Grantham, found the average monthly return from October 1 to April 30 was +2.5%. This seven-month period in the pre-election year (year three) showed a phenomenal total

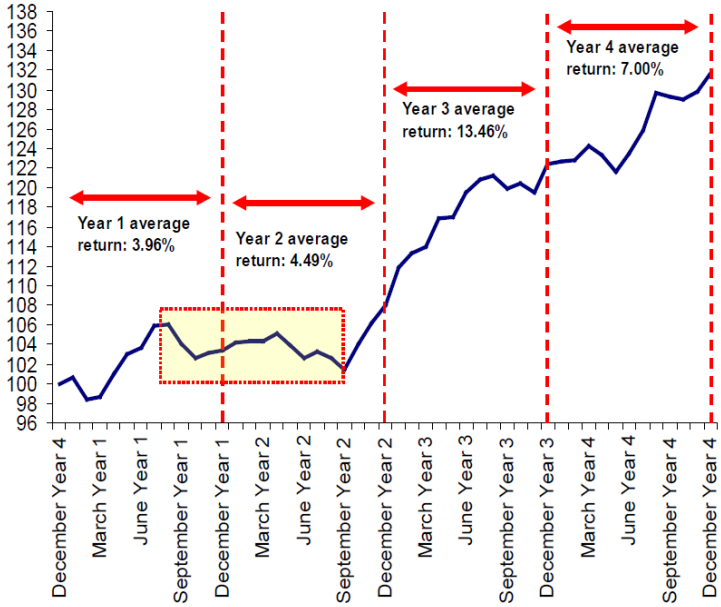
return, on average, of 17%. In addition, Mr. Grantham shows that 17 of 20 historical periods were positive and only three were negative, and only slightly so, with single-digit losses. The remaining months of the cycle, into year four, were decent, but nothing nearly as powerful as the third year. Given the strength in these numbers it would appear a no-brainer to stay invested during the third and perhaps the fourth year of the cycle and reduce risk or eliminate it during the first two years of the cycle. Mr. Grantham also studied returns during the cycle using different valuation levels and traditional metrics and found that the patterns still produced enticing returns during the latter years of the four-year cycle, regardless of high valuations at the time. A high stock-market valuation reading going into the third year lopped off a couple percentage points, but still returned 15%, on average annually, during the sweet spot of the third year, and bumped up to 19% if the period began with stocks being historically cheap. Valuations do tend to play a critical role in the returns of the other periods of the cycle, most notably the first two years. If the patterns repeat, it doesn't seem prudent to assume much risk when markets are overpriced and we are not in the third or fourth year of the presidential cycle.

We can be certain that history will never repeat itself exactly. But, if we ignore seasonal patterns, particularly the power of the four-year election cycle, it would be a mistake. It's also interesting to note that most bear markets begin in the first or second year after an election (typically when unpopular political choices are made) and the market later improves as a new election is on the horizon in the third and fourth years, with the administration doing everything in its power to win another four years for the party in the White House.

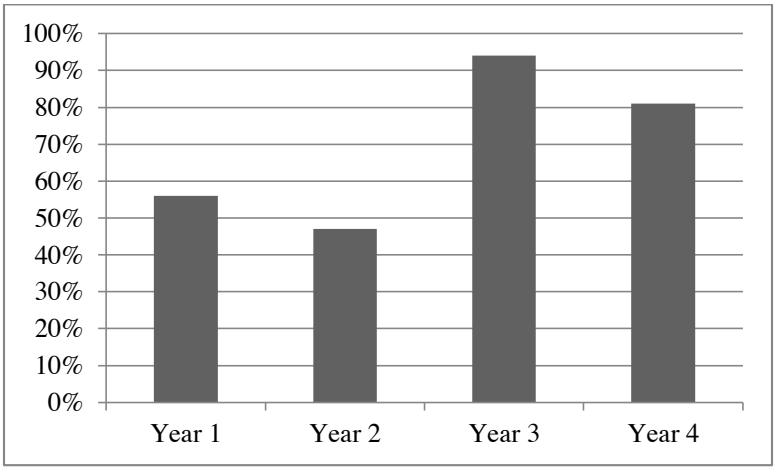
I believe valuations and where we are in the cycle, discussed in previous chapters, and readings of optimism vs. pessimism, using traditional valuation measures and your own risk tolerance

and financial situation, should help dictate your stock market allocation and how much risk you assume at any given time. However, there is no doubt that politics and the election cycle have an impact on prices. Again, pay attention to the fact that post-election years (the first couple of years following an election) are typically difficult with negative returns or even bear market declines, and the market begins improving by the third year, with the most powerful subset being the 7-month period of year three beginning October 1 and ending April 30. If history repeats itself more often than not, recognizing this simple pattern can make an enormous difference in a lifetime of returns.

Historical Presidential Cycle Pattern – 1928 through 2012

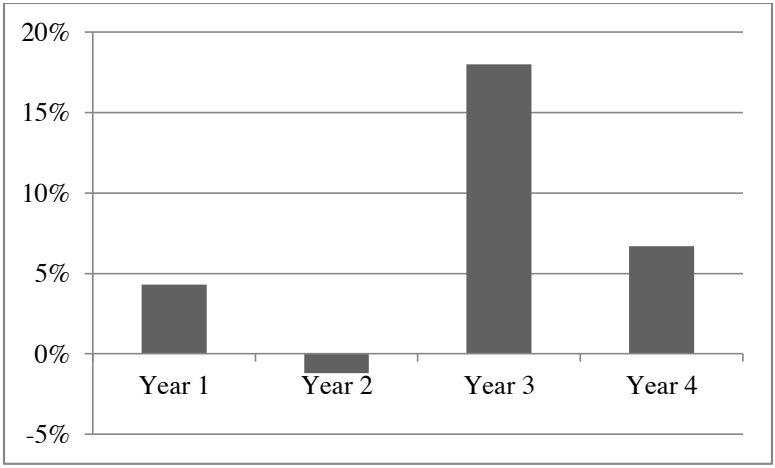


Percent of Years in which the Stock Market Increased (1946-2010)



Presidential Term Year

Median Stock Market Returns (1946-2010)



Presidential Term Year

Presidential Election Stock Market Cycle (Dow Jones)

Cycle	President	Party	Year 1	Year 2	Year 3	Year 4
1833	Jackson	Dem	-1%	13%	3%	-12%
1837	Van Buren	Dem	-12%	2%	-12%	6%
1841	WH Harrison	Whig	-13%	-18%	45%	16%
1845	Polk	Dem	8%	-15%	1%	-4%
1849	Taylor	Whig	0%	19%	-3%	20%
1853	Pierce	Dem	-13%	-30%	2%	4%
1857	Buchanan	Dem	-31%	14%	-11%	14%
1861	Lincoln	Rep	-2%	55%	38%	6%
1863	Lincoln	Rep	-9%	4%	2%	11%
1869	Grant	Rep	2%	6%	7%	7%
1873	Grant	Rep	-13%	3%	-4%	-18%
1877	Hayes	Rep	-9%	6%	43%	19%
1881	Garfield	Rep	3%	-3%	-9%	-19%
1885	Cleveland	Dem	20%	12%	-8%	5%
1889	B.Harrison	Rep	6%	-14%	18%	-7%
1893	Cleveland	Dem	-25%	-1%	2%	-2%
1897	McKinley	Rep	21%	23%	9%	7%
1901	McKinley	Rep	-9%	0%	-24%	42%
1905	T.Roosevelt	Rep	38%	-2%	-38%	17%
1909	Taft	Rep	15%	-18%	0%	8%
1913	Wilson	Dem	-10%	-5%	82%	-4%
1917	Wilson	Dem	-22%	11%	31%	-33%
1921	Harding	Rep	13%	22%	-3%	26%
1925	Coolidge	Rep	30%	0%	29%	48%
1929	Hoover	Rep	-17%	-34%	-53%	-23%
1933	F.Roosevelt	Dem	67%	4%	39%	25%
1937	F.Roosevelt	Dem	-33%	28%	-3%	-13%
1941	F.Roosevelt	Dem	-15%	8%	14%	12%
1945	F.Roosevelt	Dem	27%	-8%	2%	-2%
1949	Truman	Dem	13%	18%	14%	8%
1953	Eisenhower	Rep	-4%	44%	21%	2%
1957	Eisenhower	Rep	-13%	34%	16%	-9%
1961	Kennedy	Dem	19%	-11%	17%	15%
1965	Johnson	Dem	11%	-19%	15%	4%
1969	Nixon	Rep	-15%	5%	6%	15%
1973	Nixon	Rep	-17%	-28%	38%	18%
1977	Carter	Dem	-17%	-3%	4%	15%
1981	Reagan	Rep	-9%	20%	20%	-4%
1985	Reagan	Rep	58%	23%	2%	12%
1989	GHW Bush	Rep	27%	-4%	20%	4%
1993	Clinton	Dem	14%	2%	33%	26%
1997	Clinton	Dem	23%	16%	25%	-6%
2001	GW Bush	Rep	-7%	-17%	25%	3%
2005	GW Bush	Rep	-1%	16%	6%	-34%
2009	Obama	Dem	19%	11%	6%	7%
2013	Obama	Dem	27%	8%		

5

Second-level thinking

You must be more right than others…which by definition means your thinking has to be different.
-Howard Marks

SECOND-LEVEL THINKING is a term that institutional money manager, Howard Marks, coined in his book, *The Most Important Thing: Uncommon Sense for the Thoughtful Investor*. Mr. Marks is one of the few money managers in existence that is worth paying attention to – every word, and I follow his thoughts religiously. Why is he different and why would his opinion matter when hundreds, if not thousands, of other money managers and analysts out there seem equally educated and qualified? It's simple – it's his ability to think differently.

According to Howard Marks, the typical investor, or money manager, only thinks at the first level. First-level thinking is obvious, superficial and conforming. Anyone can do it. Here are some examples of first-level thinking:

"El Pollo Loco is going public. I love their chicken burritos and tacos – let's buy it."

"The stock market is plunging and the economy is slowing down – let's sell all our stocks."

"Apple just came out with a new iPhone and it's so popular I can't even buy one. I'm on the waitlist. This company can't do anything wrong – let's buy it."

"Toyota is recalling a million cars because of faulty brakes – let's sell."

Basically anyone can be a first-level thinker, but this simple way of thinking is not enough to make you a successful investor. It is enough to make you an average investor, I'll give you that. Why? Because pretty much the entire investing public thinks at the first level and will go over a cliff together, as it did in 2000 and again in 2008-2009, when markets imploded and lost over 50% of their value. Investing is at least as much art as it is science so one's approach should be creative, intuitive, adaptive, and often, contrarian. This is where second-level thinking can help you.

Second-level thinking involves intuition, insight and an awareness of psychology. It's intense and complex and requires one to think objectively, critically and skeptically. It also means drawing often unpopular conclusions the first-level thinker never considers.

Using the same examples as above, let's look at how the second-level thinker might interpret news and think differently:

"El Pollo Loco is going public. I love their chicken burritos and tacos."

Second-level thinker: "But, everyone else loves their food too and I know that. Let's look deeper into the company and market psychology of the public leading up to the Initial Public

Offering. The company is poorly run, it's cash-poor and has an unhealthy balance sheet. If the stock runs up a lot at the IPO it will clearly be overvalued and unable to live up to expectations. Let's short the stock after the IPO."

"The stock market is plunging and the economy is slowing down."

Second-level thinker: "Yes, stock prices have dropped fast as sellers are panicking and dumping shares. Since the economy is slowing, the Federal Reserve is more likely to remain accommodative longer than the consensus expects and this should ultimately be good for stocks. Let's buy stocks while they are at bargain prices while irrational, emotional investors are selling out."

"Apple just came out with a new iPhone and it's so popular I can't even buy one."

Second-level thinker: "The stock has run up in anticipation of the new phone and is overpriced at these levels. It's not a good risk vs. reward scenario as all the good news is probably priced into the stock. Let's pass on this purchase and look for better value elsewhere."

"Toyota is recalling a million cars because of faulty brakes."

Second-level thinker: "The stock is plunging on the news, but it's a quality company, a global leader in its industry with an excellent balance sheet and billions in cash to cover the cost of the recall, which is minimal. Let's increase our allocation on the negative news – let's buy more."

While the first-level thinker is simplistic and draws a popular, consensus conclusion, the second-level thinker involves more complex thoughts that require deep thinking and analysis. "What

is the probability I'll be right?" "What is the worst-case scenario?" "What if the consensus is actually right on this one, at least for a while?" "Is this news factored into the current price?" "Is the consensus too bullish or too bearish?" "If I'm right, how will it be reflected in the stock price?" "At what level is there value?" The second-level thinker tries to imagine every possible scenario and outcome.

So, if first-level thinkers look for easy answers, the opposite is true of second-level thinkers. Second-level thinking is exhausting and complicated. While the first-level thinker may draw the same conclusion as most of the investing public, the second-level thinker will try hard to think beyond the obvious – to think differently. Remember, you can't think and act the same as others and expect to have different results. So, if you are looking to do better than average, and avoid a 30% decline in stocks when the next bear market inevitably hits, you must think and behave differently. Second-level thinking is the answer.

For your investment performance to be different from the norm you have to be more right than the consensus. Since most investors consider the investment process simple and don't even know that second-level thinking exists (they haven't been taught or are incapable of thinking in this manner), this allows the deeper thinker to have the potential to prosper and earn above-average results. At a minimum, the second-level thinker's investment goal should be to earn better risk-adjusted returns than the first-level thinker.

6

Madness of crowds

The ability to think differently or against the crowd at times, and define and recognize risk, is critical to a lifetime of investment success.

THE BEST CLASS I TOOK as an undergraduate student taught me how to think objectively, question authority and form my own opinions. It also taught me to think from the writer's perspective and understand why he or she held a certain belief. Most importantly, the course taught me to think differently, at times unlike the consensus or crowd, and this has helped me immeasurably in my career as an investment advisor and manager. The way of thinking that I was taught as a 20-year old isn't unlike second-level thinking. Second-level thinking forces us to think deeper and work harder to understand how an opinion or belief, particularly by the crowd (mainstream investors and the consensus opinion of money managers), could have consequences the first-level thinker doesn't even consider. As an investor, this way of thinking objectively, critically, skeptically and often against the crowd, can help you survive difficult markets and prosper when others are suffering losses.

Since most of our investing decisions are made emotionally and without an understanding of investor behavior and psychology, most investors also think alike and form similar opinions. Unfortunately this consensus thinking and herd mentality can lead to terrible mistakes during difficult markets. We've already covered how markets are often pushed to extreme valuations driven by fear and greed. Let's look deeper into this topic to learn how we can think differently at critical times and not participate in the madness.

Investors want to make money and they fear missing out on gains during a bull market. They compare themselves and their performance to others and don't want to be left out. The second-level thinker who is mentally tough and thinks differently has the ability to recognize when this is happening and why, and avoid the frequent mistakes made by the herd.

I believe markets are inefficient and mispricing happens daily – let's call them mistakes. To profit from the mistakes of others we have to think differently and unemotionally. We have to look deeper into investor behavior and understand how market psychology influences investors and why those decisions often

lead to losses. If we allow ourselves to think like the crowd at market extremes (during bubbles and subsequent crashes) it can lead to awful investing decisions and downright poor results.

Greed

While there is certainly nothing wrong with desiring money or high profits, when investing, greed can lead you astray. Greed is a powerful human emotion that can push one to make investing mistakes that might ordinarily be avoided or minimized. Those times when greed and blind optimism convince you to pursue paths taken by the herd, with the hope of greater profit, could ultimately lead to your demise. You must control or eliminate greed to invest well, and it certainly can pay well to recognize when the markets are governed by the greed of the participants – just make sure you are not one of those players during times of extreme optimism and overvaluation.

Fear

Another powerful emotion to be aware of is how fear can influence investing decisions. Fear usually involves the avoidance of risk and it often rears its ugly head just at the wrong time. When fear is overdone and panic sets in and prices plunge, the second-level thinker unemotionally steps up and purchases stocks at bargain prices. The investor who doesn't recognize how fear drives markets and behavior will miss out. Even worse, not recognizing the times when fear is overdone can lead to disastrous investing mistakes and outcomes.

Herd mentality

The last psychological factor I will highlight that leads to poor investing decisions, is our desire to think and act like the herd or crowd, rather than resist. It takes the ability to think differently (second-level) to avoid being sucked into the crowd's belief that

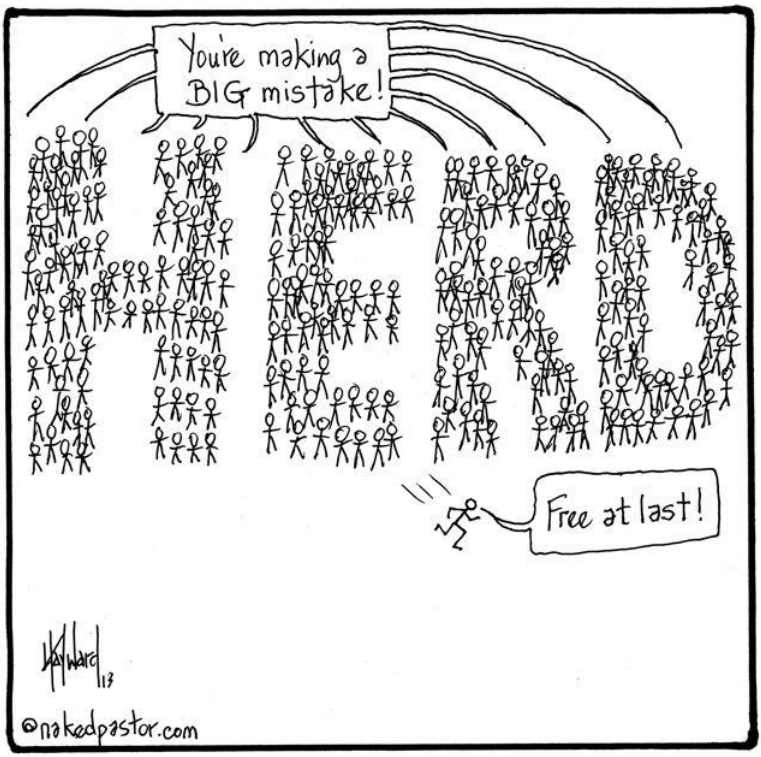
"this time is different," valuations are compelling and more profits are on the horizon, even though history and common sense tell you otherwise. At the top of an asset bubble, the pressure to conform and fear of missing out when others are enjoying the ride can be overwhelming. Many investors capitulate and join in just when the ride is about to end. And, we often see the reverse at market troughs – emotional investors following the herd often bail on positions, panic and sell, just when the market is close to bottoming out, sentiment is as negative as it is ever going to get, and bargains are plentiful.

The human desire to have more and the powerful influence of the herd are present in all markets. It is our collective behavior that allows prices to hit extreme irrational levels, both high and low, and the pattern repeats itself over and over. To avoid losing money during bubbles and profit from opportunities created by the crowd during crashes, one must refuse to join in the madness. Few people can avoid the temptation, but if you understand how psychology influences the behavior of others, and have an understanding of market cycles, you can survive and even flourish as an investor. Resist the temptation to join the madness.

Here are a few bullet points to help keep your emotions in check and your investment strategy on track:

- Recognize where we are in the market cycle. Are we close to one extreme with sentiment and prices possibly set to reverse trend?
- Define how markets are priced – are they expensive or cheap relative to historical values?
- Notice how other investors are behaving. Are they giddy with enthusiasm and greedy for more gains, risk averse, or somewhere in between?

- Resist the temptation to participate in overvalued markets or at least reduce risk as a bubble inflates. Sell on the way up.
- If it seems "too good to be true," it most certainly is.
- Be willing to look like a fool for a while and not participate at market tops when easy money is being made by the crowd. Your patience will be rewarded.
- Think differently. Employ second-level thinking. Question and think objectively. Remove your emotions.



7

2-sigma events – bubbles

Bubbles are driven by psychology and lead to massive mispricing.

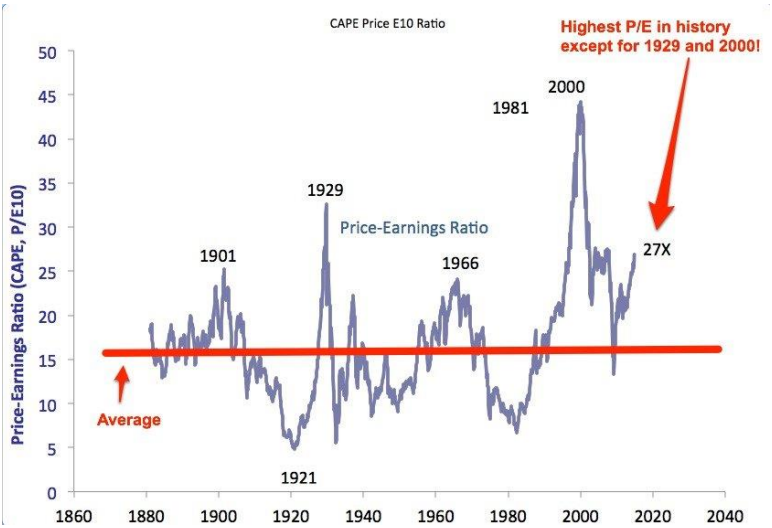
DESPITE THE FACT THAT MOST of us cannot recognize a bubble when we are in one, it is fairly easy to define – periods of wild speculation and enthusiasm punctuated by rapidly rising prices, valuations and the anticipation of even higher prices in the future. Bubbles are driven by psychology and human behavior and lead to massive mispricing and are always followed by crashes. But, this simplified definition of a bubble doesn't help much when trying to manage money and control risk.

The best definition I have seen of a bubble, which quantifies it for us, comes from the money management firm GMO and its unparalleled leader, Jeremy Grantham. GMO has spent a lot of time studying the history of markets, boom and bust periods and historical pricing of all asset classes. Back in 1997, while the stock market was inflating to what would become the biggest equity bubble in history, GMO felt compelled to define bubbles in a way that would help them better control risk and adjust their portfolios accordingly – to quantify the event. They studied data of 28 major bubbles in history and found that they all had one

similarity that they could quantify – a two-standard deviation event (2-sigma). Quite simply, they defined a bubble as when an asset class moves two-standard deviations beyond the long-term price trend or valuation level.

2-sigma events should happen every 40 years or so, if we look at the historical variance of distributions. However, in the recent past we have had many more bubbles, in numerous asset classes, so the study and understanding of bubbles is not only pertinent, but necessary if one hopes to capture returns during a boom period, but not be wiped out during the inevitable bust.

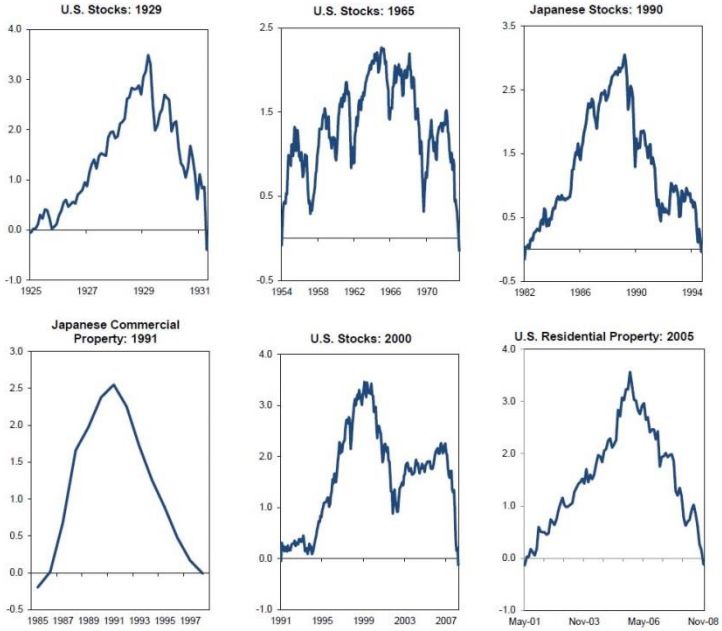
To better understand a 2-sigma event, think of it as a market that is valued far outside the norm – the norm being a level where one would typically see a normal distribution of returns or a long-term price trend. For stocks, a 2-sigma valuation level could be defined as a CAPE ratio (cyclically-adjusted price-to-earnings) of approximately 29. The current CAPE in 2015 is 27, so we are again flirting with dangerous levels.



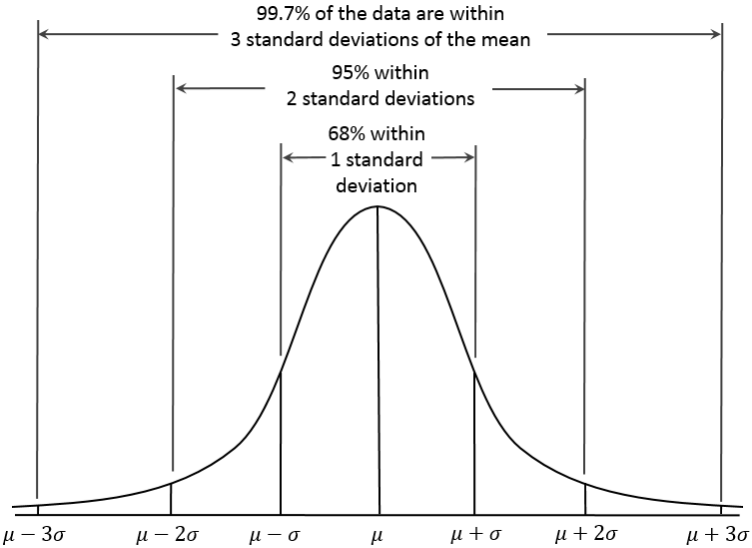
For some historical perspective, GMO defined the *Six Most Important Asset Bubbles in Modern Times* and found the year 2008 to have been unique in that we had more global overvaluation than at nearly any other point in history. Our own U.S. equity markets weren't at the same standard deviation as we saw in 2000, but our housing market hit beyond 3-sigma territory and GMO found 40 countries that showed readings of over one sigma at the time. While nothing nearly as extreme as a 2-sigma event and the risks associated with that level of pricing, 1-sigma events were still only expected to occur once every six years. So, with many global markets at or nearing bubble territory – real estate, stocks, commodities, oil and precious metals – 2008 was probably the biggest outlier in history. We all lived through the global financial crisis and the aftermath (Great Recession) and our economies are still adjusting to the correction in pricing that occurred.

My best guess tells me that if more money managers and investors had a better understanding of 2-sigma events and the dangers of being fully invested (or even levered-up) near market tops, the fallout from the most recent crises would have been more manageable. Actually, if more investors had a better understanding of bubbles we certainly would have fewer of them. Yes, much of the blame for the multiple bubbles of 2008 can be placed on the Federal Reserve and its easy-money policies and its inability to recognize risk and bubbles, but it's even easier to just call what happened human nature and greed. The investing public and institutional investors didn't want the party to end and certainly wanted to participate all the way up, with little concern about losing money. Our economy and society eventually paid the price.

Exhibit 1: The Six Most Important Asset Bubbles in Modern Times



Source: GMO, Global Financial Data



8

Characteristics of a bubble

The recognition of a bubble is crucial to avoiding large losses.

WHILE WE CAN QUANTIFY A BUBBLE as a 2-sigma event (thanks to the work done by GMO), where prices move two-standard deviations above an historical price trend line or valuation level, we can also somewhat easily identify a bubble by the behavior of the market participants. Let's briefly look at how investors feel and behave as markets build up to unsustainable levels and then crash – the complete cycle.

Psychological build-up of a bubble:

Depression – Hope – Relief – Optimism – Excitement – Thrill – Euphoria

Psychology of a crash:

Anxiety – Denial – Fear – Desperation – Panic – Capitulation – Despondency

Let's start with studying investor behavior as we work our way to the top of a bubble into the euphoric stage. A bubble will usually get started as a result of a change in the investment landscape that creates an opening for a new opportunity. Or, perhaps it is the result of a drop in interest rates and easy money policies of central banks to facilitate lending and borrowing in order to spur growth. If the effect is big enough, it will generate an increase in growth, economic activity and positive consumer sentiment and spending. New money will flood the marketplace into whatever industries are showing the greatest growth potential and profit. Often real estate and stocks will move up in tandem as growth in profit margins and the hope of an even better future give investors renewed confidence.

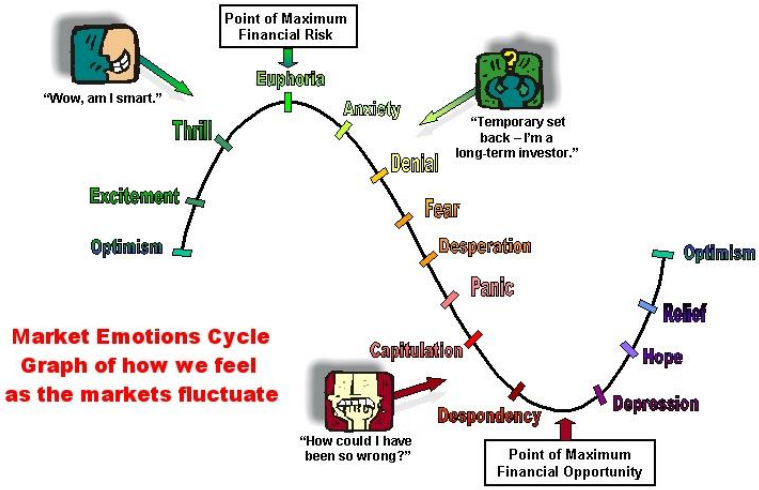
At some point, the optimism and excitement will reach a level where it is not only thrilling and euphoric, but also unsustainable. Price trends and valuations move far beyond traditional levels. Eventually price appreciation will slow and reach a level where further gains are impossible and a slowdown becomes inevitable. The ensuing decline can come swiftly in the form of a crash or more slowly, but the market's action and general direction during the downtrend is obvious. Any temporary price gains are met with selling as investors try to liquidate positions. As markets decline, investors begin to feel anxious and then denial sets in. Buyers go on strike and no offers materialize in what was once a very liquid seller's market – all asset classes can suffer large losses in the aftermath of a bubble.

The emotions of fear and desperation are followed by even stronger feelings that ultimately lead to panic, capitulation, despondency and depression. After the last of the sellers have sold and negative sentiment is widespread, this clears the way for a period of new growth and a new cycle begins. John Calverley, in his excellent work titled, *When Bubbles Burst:*

Surviving the Financial Fallout, provides a checklist of some the characteristics of a bubble and what to look for.

Typical characteristics of a bubble:

- Rapidly rising prices.
- High expectations for future profits.
- Overvaluation compared to historical averages.
- Overvaluation compared to reasonable levels.
- Several years into an upswing.
- Some underlying reason for higher prices.
- A new element, e.g. technology for stocks or immigration for housing.
- Subjective "paradigm shift."
- New investors attracted to the market.
- New entrepreneurs.
- Considerable popular and media interest.
- Major rise in lending.
- Increase in indebtedness.
- Consumer price inflation often subdued (so central banks are relaxed).
- Easy monetary policy.
- A falling household savings rate.
- A strong exchange rate.



Let's look a little deeper into some of these characteristics of a bubble to better understand the animal spirits we are dealing with, and specifically, where we stand today in 2015.

1) *Rising prices and valuations*. After a near 6-year bull-market run in stocks, the current CAPE valuation level is 27, some 70% above trend line. We are close to a 2-sigma event, with upside from the current Dow Jones Industrial reading of 18,000, to approximately 19,000. At that valuation on the Dow Jones and 2,250 on the S&P 500, we will have reached a 2-sigma level and be on par with past extreme bubbles that subsequently crashed. Note, the long-term trend line historic CAPE reading is 16.5.

2) *New paradigm*. The "this-time-is-different" mentality is alive and well in our current market. With U.S. profit margins at peak levels, we hear talk that they may still be sustainable and are justified by historically low interest rates. The same can be heard when analysts admit stock valuation levels *appear* well above norm by historical standards, but they don't suggest selling, rather, they tell us stocks are actually at fair value levels relative to low interest rates. So, this time we can justify buying stocks at

extremely elevated prices and still count on further gains, because low interest rates support and justify high stock prices. They also argue that stocks are a good value because there are no other attractive alternatives. So, by default stocks deserve your money – or so the argument goes.

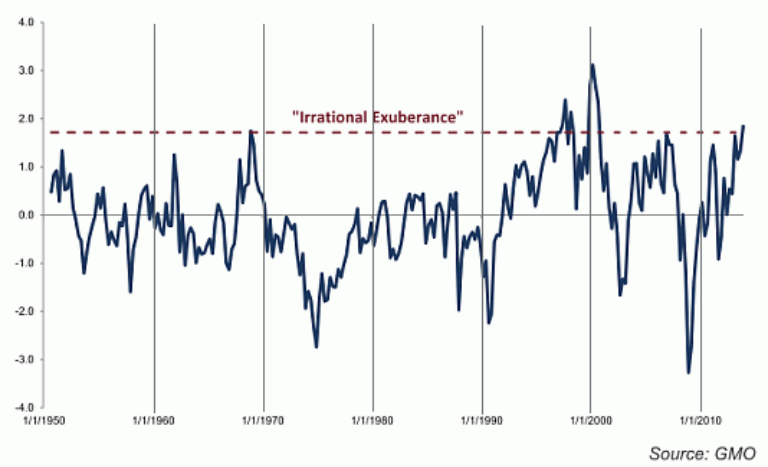
3) *The Fed's easy money policy*. The housing bubble finally burst in 2006, and the stock bubble in 2007 – many other global bubbles followed suit. These bubbles, in addition to the current one fast approaching, were exacerbated by the Federal Reserve's insistence on keeping interest rates at historically low levels in an attempt to encourage investors to buy both real estate and stocks. The three most recent Fed chairs, Greenspan, Bernanke and Yellen, have all had our backs and will continue to bail us out with stimulus and low interest rates in order to support asset prices and create the wealth effect. This is the current thinking too – as long as the Fed is on our side it's okay to speculate because nothing will go wrong – the Fed will save us.

4) *Media interest and great growth stories*. "Conservative" stocks have more than doubled in the past 6 years and some growth stocks have tripled or better. Small-cap stocks, typically the most speculative of the bunch, have increased close to 300% since they bottomed in March 2009. Homes are selling again with multiple bids on the first day they are listed. Sellers are clearly in control again as buyers are afraid of getting priced out of the market. Venture capital is throwing money at firms, once again, with the hope of striking it rich. Popular stocks like Facebook and Twitter have yet to show sustainable profits yet trade at ridiculous valuation levels. The thinking is the current valuation doesn't matter – it's all about the future and having a hold on the public through social media – a new paradigm. Sound familiar? I feel like we have learned little since the global bubble environment of 2007 and the subsequent crash, despite all the pain that was inflicted and the fact that it was quite recent. In

many markets and asset classes, we are right back where we were – it's becoming evident in stocks, bonds, real estate, art and other collectibles, like classic cars. Can you say déjà vu?

GMO Market Sentiment Indicator

GMO has put together a sentiment indicator that is worth studying and shows we are once again at or near valuation levels and bubble territory that would rival past bubbles in 1968, 2000 and 2007. GMO combined some 20 traditional sentiment readings such as insider selling, bullish/bearish newsletter readings and leverage and volatility to come up with its own sentiment model. The findings indicate that while we are not at the same euphoric readings of some historical bubbles, we are mighty close – recognizing these risks now could help keep you solvent during the next downturn. From current levels, my take is that both stocks and real estate will have a difficult time posting positive average annual returns, after inflation, over the next 5 to 7 years. And, they are probably more likely to show negative returns with little capital gain potential.



9

Behavioral finance

One small event can lead to a large reaction or "tipping" point.

CONTRARY TO THE VIEWS HELD by academicians and conventional finance theory, given the times we live in and extreme price volatility evident in recent bubbles and subsequent crashes, the argument against market efficiency speaks loudly. The efficient market theory states that since all information is available to all market participants at any given time, then prices are always correct and appropriate. It further states that investors are rational and mispricing doesn't exist – basically that bubbles don't exist either. Nothing can be further from the truth as markets are governed by the emotions and behavior of irrational participants.

The study of behavioral finance is relatively new, but provides critical evidence and theories that further support the existence of bubbles and seeks to explain why investors are sometimes irrational and markets mispriced. I'd like to briefly review the more interesting and popular theories of behavioral finance as I believe it is important to recognize them in order to better understand why we behave the way we do and how our behavior

affects markets. The following concepts in behavioral finance will help explain why investors are often irrational and make poor financial decisions.

Anchoring

The concept of anchoring is our tendency to draw a point of reference, or anchor, in our decision-making process, though it has no relevance. In investing, our reference point may be the purchase price we paid for a security, which of course, is of no interest or importance to anyone else. For example, if you purchase a stock at $50 and that price becomes your "anchor," you may be inclined to think that when the price drops to $40 it will invariably come back to $50, so you might be inclined to buy more at the lower level. The problem with this thinking, of course, is a price of $50 (your price) has nothing to do with why the stock has fallen to $40 and also doesn't mean the stock will eventually recover to your anchor price. Heck, it may never see $50 again in your lifetime.

Price anchoring can be dangerous as bubbles build. The more we believe the market is anchored at a certain level, the more we think it is justified and is the "correct" price. In today's current market, after a six-year bull market run, the Dow Jones priced above 17,000 seems totally rational and acceptable. Anchoring the market at 17,000, as some participants may do, can make one believe that it is supported at that level and priced appropriately. But several years prior, when the market was trading at Dow 10,000, a price of 17,000 would have seemed irrational and unjustified. The fact that we got there, moved through 17,000, and have not seen that level for many months can blind us into thinking that it represents a good value and we may therefore put even more money to work in stocks – which can also contribute to the formation of bubbles.

Another simple example of anchoring can be seen in the historical returns of the market itself. Journalists, investment advisors and money managers may tell us that the market returns on average, 10% per year, and has been doing so for over 80 years. This is a wide investment sample, but is it relevant and can we apply the expectation of a 10% return to any market environment? What if the market has returned nearly 200% in six years (as it has recently), can we still believe it will give us another 10% averaged annually, from today's levels? Rational investors would assume that this would not be the case and that future returns would be below average – believing we are due for some reversion-to-mean. However, with anchoring, we may believe that since stocks have been delivering positive returns of at least 10% annually of late, they will continue to do so in future years. Surveys have consistently shown, for both real estate and stocks that recent returns influence participants the most and they typically believe those returns will continue in the future. This is dangerous and irrational.

Loss-Aversion Theory

It is easy to understand why we would prefer an investment that guarantees a positive return or gain to an uncertain one. We certainly want to get paid if we are taking more risk. But, prospect theory suggests we have differing degrees of emotion when looking at gains and losses. If your advisor captures a $100,000 gain for you, you might not be prompted to call and congratulate him, but if a $100,000 loss is realized you may instead question the advice you were given and you would certainly be unhappy about it. The loss affected you more than the gain even though they were the same dollar amount. A loss will always appear larger than a gain of equal size – we have an aversion to loss.

Loss aversion can also help explain why investors have difficulty selling a losing stock. Investors will often choose to assume more risk, to simply avoid taking a loss. You might sit on a stock because it shows a loss in your portfolio, hoping it will get back to your original price, even though you view the stock as more risky now than when you first made the purchase. And, gamblers or aggressive investors will often double down, investing more after a decline with the hope of quickly recouping what was lost. It's interesting how we often value a stock we already own, particularly if it shows a loss, much higher than what the market believes is the correct price.

Loss aversion can help explain why bubbles inflate. Normally one would think that because we have an aversion to loss that we would not be inclined to buy stocks or real estate as prices go higher and higher. But, what happens in a bubble is investors start to think that losses are not only unlikely, but even impossible. We develop faith and believe stocks only go up or that real estate will be a good investment forever, from any level. So, the usual feelings of loss aversion that investors have, which normally could temper their buying enthusiasm, are ignored in market bubbles because investors think the positive returns will continue and losses are no longer possible. Think about how you felt at market tops in 2000 or 2007, or at recent bull market peaks in other asset classes (e.g. oil, gold). Most investors felt the gains would continue, losses were unlikely, and many were even willing to invest more near the top, thinking further gains were inevitable. This is another example of irrational behavior.

Regret Theory

The fear of regret deals with how investors react after realizing they have made an error in judgment or a mistake. If you purchase a stock and it subsequently declines, regret theory states that you will not sell the loser because you are emotionally

affected. So, you avoid selling it because it will lead to regret – the regret of having given up hope of recouping your money. The problem here is that, because of our emotions and how we process losses, even if unrealized, it can make us turn what might be a small loss into a much larger one. If a stock has declined to a certain value and you are losing money on it, ask yourself if you would purchase it at the new, lower level. If your response is "no," then why in the world wouldn't you consider selling it? So, by feeling regret over having a losing stock in your portfolio, it keeps you from selling and this can often lead to even more regret. You become paralyzed and refuse to act, and what was once a small loss may turn into a much larger one. This can also explain why investors who participate in market bubbles and have a heavy allocation at market peaks, refuse to sell as markets begin to decline. Regret, as it relates to investing, can be a powerful emotion and it can cause much financial pain.

Theory of Critical Transitions

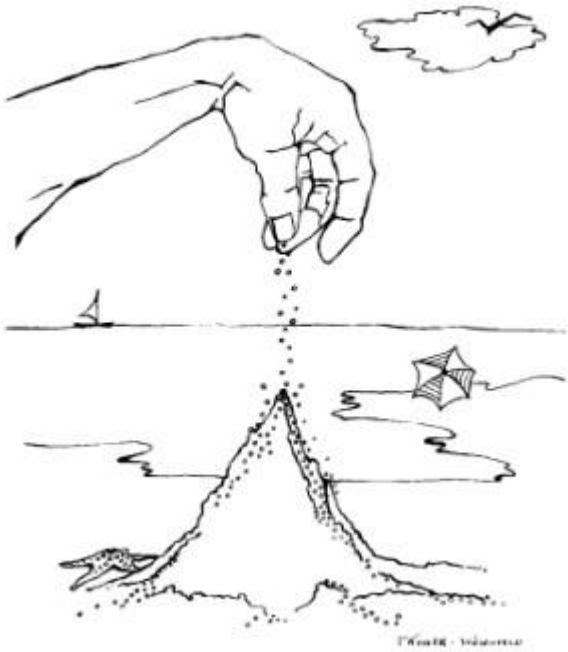
The theory of critical transitions, also referred to as critical state theory or tipping, is the belief that one small event can lead to a large reaction or "tipping" point. While the theory is complex, it can be boiled down to a somewhat simple way of trying to understand how systems can have tipping points where a small push can cause a critical transition to a contrasting state. Mathematics suggests that some aspects of behavior at tipping points are universal and can help explain, in particular, why market bubbles ultimately pop and crash.

If a system has alternate stable states, like the stock market for example, slowly changing conditions can make the system vulnerable to a collapse into a contrasting state. I like the metaphor of sitting in a canoe and leaning over to one side to touch the water. If you lean over too far you may cause the canoe to tip over and capsize – and end up in an alternate state (and

wet). But, it is difficult to know exactly when that tipping point will occur, as the boat changes position perhaps only slightly just up until the critical tipping point. Furthermore, as you get close to the tipping point, even the smallest disturbances, wind or waves, which normally might not cause a change to a contrasting state, can tip the balance.

If we apply the theory of critical transitions to the stock market, particularly in the bubble phase, the thinking is that it is impossible to know exactly when or why a bubble will pop. And, the "tipping" point may arise not necessarily out of a spectacular event that is obvious. The "event" may well be the bubble itself as it simply reaches a level where it has become vulnerable to the smallest of disturbances. John Calverley, in his book titled *When*

Bubbles Burst: Surviving the Financial Fallout, offered another metaphor which helps better understand the theory. Imagine someone with a handful of sand trickling grains on a flat surface. A small mound forms and over time the mound grows, but from time to time it reaches a point where it collapses and crumbles. Just as in the example of the tipping canoe, with the pile of sand we are unsure exactly which additional grain of sand on the mound actually caused the collapse. Predicting which grain of sand caused the landslide is impossible – and so it is with a market bubble, it can inflate to such a level that ultimately it collapses of its own weight, not necessarily because of some specific event. Unfortunately we cannot know in advance exactly what will cause the collapse.



While we cannot know for certain what causes a market to finally tip to an altered state and collapse, I believe we can identify markets that are moving into a critical state or bubble. I have already highlighted some of the characteristics to look for and it is of utmost importance that you identify a bubble before it unravels and losses mount. At some point we would hope to be able to say, for example, that there is a 90% probability that we are in a bubble. If that is the case, risk reduction and control will obviously be critical.

It should be clear that behavioral finance has shown many examples of irrational behavior by market participants and many events (bubbles and crashes) that prove that the efficient market theory is not credible. Please recognize that markets and their participants will not behave rationally or predictably.

10

U.S. housing bubble – a brief history

The U.S. housing bubble nearly took down the financial system. A 3.5-sigma event should not have happened in our lifetime.

ACCORDING TO THE EXTENSIVE research done on the history of bubbles by investment firm GMO, the U.S. housing bubble of 2006 shouldn't have happened – or at least not in our lifetime. Prices got so extreme they registered a 3.5 standard deviation (3-sigma event) away from the historical price trend line. If one does the math, this should happen once every 5,000 years!

Price gains leading up to the bursting of the bubble in 2006-07 recorded over 130% for the national average over the 10 years leading up to the tipping point. In some areas where widespread speculation was rampant, prices climbed well over 200% during the same time period. Markets like Los Angeles, San Francisco, New York, Miami and Las Vegas were some of the standouts. When prices finally collapsed, they didn't simply affect local markets that were ripe with speculation, they nearly took down

the entire global financial system. Let's look at a brief history of the housing bubble to see what went wrong and why.

We know bubbles are characterized by prices typically reaching levels far above historical trends and valuations, being pushed to high levels by enthusiastic, greedy individuals displaying irrational behavior with little concern about risk or potential loss. The housing bubble that we recently lived through had all the elements of nuttiness and there were some very specific reasons for the bubble. For some perspective, in the decades leading up to the housing bubble, we experienced two other bubbles of smaller magnitude – 1979 and 1989. But the most recent bubble, which began in the early 1990s and really picked up steam in 1997, was a direct result of mistakes in government policy measures and the Federal Reserve.

To begin, in 1997 there was an elimination of capital gains taxes on profits of up to $500,000 on residential real estate. Then, in 2001, during a recession that normally might have pricked the housing bubble before it got to outrageous heights, the Federal Reserve decided to launch a very expansionary monetary policy in order to counteract slowing growth and a stock-market bubble that was unwinding. With the Fed furthering easy money policies and liquidity, money flowed quickly to the sector of the economy that was expanding with apparently unstoppable price appreciation – real estate. There also wasn't much competition from other asset classes as stocks were clobbered – the only game in town was real estate. Both the Clinton and Bush administrations also aggressively pushed home ownership and credit standards were loosened in order to allow as many home buyers as possible into the market.

Lenders and investment banks that securitized mortgages used rising home prices to justify loans to otherwise unqualified buyers. Loans with no-money-down or a 5% down payment, and

no income verification, were offered to anyone who could fog a mirror. The participants believed there was no way they could lose money since house prices only rise. True, from an historical perspective, house prices in the U.S. had not fallen for more than one quarter since the 1930s, so the investing public "believed" and was eager to go along for the ride as policy makers and lenders made it as easy as possible to play the game. Rating agencies were also on board as they accepted the assumption of ever-rising home prices to justify giving investment-grade ratings to otherwise risky packaged mortgages backed by poorly written loans.

House payments in the U.S. typically use up about 30% of one's salary, but with prices more than doubling in the decade leading up to 2006, there was no way incomes could rise enough to justify the advance and keep the party going. At some point demand would dry up – it was just a matter of time. Even with all the creative lending options out there to encourage typically unqualified buyers to borrow and participate (interest-only adjustable-rate mortgages and subprime loans packaged as investment-grade), the bubble had finally reached its tipping point.

In 2006 prices began to decline and those policies that had helped promote record levels of home ownership finally backfired. The trillions in loans written to poorly qualified borrowers began to unwind as prices declined. Jobs were lost, the economy slowed and delinquencies and defaults started to rise. Since most investors had only made small down payments for their purchases (and walked away from properties when they showed negative equity), it was the large lending institutions that suffered the biggest losses.

The reasons for the bubble – easy monetary policy by the Federal Reserve, tax-free capital gains, relaxed and poor lending

standards – had provided unheard of stimulus to the economy. But, when the bubble began to unravel, there was no stopping it. Prices began to fall and warning signs clearly appeared in 2007. By mid-2007 prices had already declined in the teens in various markets and the issuance of mortgage-backed securities and other new loans that had fueled the speculative advance dried up and the trouble began. According to First America CoreLogic, over 10 million households had negative equity by the end of 2008. Homeowners with negative equity, no or low income, poor job prospects or security and little additional assets, faced foreclosure. And, the remaining losses had to be absorbed by the financial system that had created the bubble. The crisis was widespread and devastating as trillions of dollars of equity evaporated.

It's worth noting why the stock-market collapse in the early 2000s didn't have the same negative impact on the economy and households as the collapse of the housing bubble. In the early part of the decade, declining stock prices were absorbed by individuals and institutions that owned the assets outright – only a small fraction of stocks were purchased with borrowed money. With housing it was the opposite, since real estate had been purchased with 90% or more financed (total mortgage debt more than doubled from 2000 – 2007, rising from $4.8 trillion to $10.5 trillion). As prices in some markets declined by 30% to 50% and home equity was lost, those huge losses were assumed by lending institutions, issuers and holders of mortgage-backed securities and insurers of the securities too. The origins of the housing crisis can be found in the leverage created by the system (unlike the prior stock bubble), passed on to and accepted by the consumer, and ultimately transmitted to the financial sector and its institutions.

The housing bubble was created by the belief that house prices would never decline. At worst, the belief was prices would

stabilize or not rise as fast, but certainly not decline. So, if house prices couldn't decline, there was little risk in home ownership and speculating in housing and leveraging up seemed to make sense. Our Federal Reserve, government and large lending institutions supported the bubble with easy money policies and encouraged home ownership even among poorly qualified buyers by providing easy access to loans. This led to a doubling of mortgage debt in only a few years and rampant speculation and price appreciation – a 3-sigma event occurred – so rare we will probably never see one again of the same magnitude.

11

Defensive-minded investing

While there is much we cannot control when investing, we can maintain a focus on defense and minimize risk at appropriate times.

DEFENSIVE-MINDED INVESTING is an approach or strategy that focuses on risk first and return is secondary. By risk, I am referring to the possibility of loss of capital, perhaps permanent, and if you don't pay attention to it, or you are simply an "offensive-minded" investor looking to hit home runs, it's likely that in certain market conditions and cycles your portfolio may not survive.

If your investment objective is both preservation of capital and moderate growth, as it is for most of my clients, there is a need to constantly weigh both objectives. Let's face it, they are opposites – you cannot have growth while preserving capital (assuming no risk whatsoever), so there has to be a balance and astute money managers and advisors are constantly trying to find the appropriate balance given the risk profile of their clients and their investment objectives. For the portfolios I manage, I would say most of my clients have the investment objective of moderate growth and income with the goal of assuming enough

risk to generate returns sufficient enough to outpace inflation and taxes. In addition, while they accept some volatility and are not too uncomfortable when returns show variance, they prefer to have minimal drawdowns while hopefully obtaining moderate growth. This sounds reasonable, but it is challenging. In order to achieve these objectives for my clients, my management approach has to be defensive – trying to limit downside risk and losses while assuming moderate risk with the goal of protecting wealth at market extremes (when valuations become stretched deep in bull markets).

An excellent sports metaphor to help better understand the approach taken by a defensive-minded investor or manager was presented by Charles Ellis in an article published in 1975 in *The Financial Analysts Journal*. Mr. Ellis presented his thoughts on the subject by using work done by Dr. Simon Ramo, showing a comparison of professional and amateur tennis players. He described this comparison, which was analyzed by Dr. Ramo in *Extraordinary Tennis for the Ordinary Player*. In the article, he referred to professional tennis as a "winner's" game and amateur tennis as a "loser's" game.

The professional tennis player typically gets to that high level and continues to win by hitting shots his opponent can't return. These "winners" determine the outcome of the match and the player who hits the most winners will be victorious. The opposite is true in amateur tennis. If you watch a typical match at your club you'll notice that because most of us lack the skills necessary to hit winners, the amateur who can simply minimize or control his "losers" will be victorious. The winner at the amateur level can simply try to keep the ball in play long enough for his opponent to make a mistake. By focusing on defense and not losing the point, the defensive-minded amateur will typically beat most players – wear them down and basically let them beat themselves.

Mr. Ellis applied the thoughts of Dr. Ramo to investing and showed that an investor's focus should be to not necessarily go for winners (like the adroit professional tennis player), rather, to try to avoid losers (like the steady amateur performer). This defensive approach appeals to me, and is much more likely to allow you to be successful investing in all market conditions and cycles – bull and bear markets. Bottom line, there is much we cannot control, but we can maintain a focus on defense to minimize risk.

If one pays attention to risk and where we are in the investment cycle, with the goal of not losing money first (return is secondary), it is quite possible to keep close to the markets in good times and hopefully perform much better (lose less) when markets are difficult. My experience has shown that the vast majority of investment managers will certainly lag the indices during bull markets and those who adhere to defensive-minded strategies may trail the indices by even more. But, those managers who focus on risk control may be rewarded with much better overall performance and reduced volatility, when comparing returns throughout an entire cycle.

So, what type of investor are you? Are you offensive-minded with an aggressive approach, hoping to hit a home run? Or, are you defensive-minded with the goal of limiting losers and controlling risk? Are you content hitting singles and doubles? I will not work with investors who are always focused on offense because I know that when markets become difficult it will be impossible to keep the aggressive-minded investor happy. The high returns he or she was shooting for will turn into losses and a continued aggressive approach (that is the nature of this investor) will show repeated losses throughout a lengthy bear market. However, if you play defense, particularly when valuations and other metrics show risks are elevated, you will greatly increase the likelihood that your portfolio will survive the tough times.

True, the investor who is only focused on defense at all times and takes almost no risk will earn minimal returns. Those returns in our current low-yield environment will certainly not even allow you to keep pace with low inflation. So, there has to be some compromise. There has to be a balance between trying to preserve wealth, but also show moderate growth. I believe it is possible to play defense, but occasionally be more offensive-minded if opportunities and valuations warrant it. You must have some "offense" in your portfolio in order to achieve moderate growth, but it must be intelligently applied and balanced depending on market conditions and valuations. It is an ongoing process and those who are not willing to put in the work will fail.

In my opinion, a cautious approach to investing makes sense for nearly all investors and certainly for retirees or those nearing retirement. If you try to control risk and avoid terrible bear-market losses, your returns can still be good and consistent enough to allow you to be financially comfortable throughout retirement. Yes, you may miss out on some excitement near the end of a bull market when making money seems so easy, but if you aim to hit singles and doubles while investing defensively and minimizing drawdowns whenever possible, you stand a good chance of achieving your investment goals.

12

How to invest during bubbles

As valuations rise, reduce beta and risk. Sell stocks.
Then be patient and wait for your pitch.

AS LONG AS MARKETS ARE GOVERNED by the actions of irrational participants and policy makers, we will continue to have bubbles and crashes. To avoid losing money during the extremes you have to think differently and act unlike your neighbors and the rest of the investing public. Bottom line, you have to utilize your skills as a second-level thinker and be rational, unemotional and not get caught up in the moment – not let greed get the best of you.

Investors typically view markets emotionally and irrationally. When prices are rising they expect further gains and are more likely to invest more as the market rises – they feel wealthy and spend as if they are, not ever anticipating a change in the direction of the market or the state of the economy. Likewise, when markets are depressed, participants boycott and don't purchase stocks even at bargain prices (they are too afraid). During bear market declines, investors do not anticipate a

recovery and are only focused on recent losses (often paralyzed by them) so they are unwilling to purchase stocks at lower prices.

While there are many theories regarding the proper asset allocation for investors of different ages and stages in life, the most well-known asset allocation strategy of keeping the percentage of your portfolio in bonds equal to your age (with the balance in stocks and real estate), makes no sense during bubbles. If you are a 60-year old retiree and stocks are trading over two-standard deviations (2-sigma) beyond historical price trends and valuations, it wouldn't be terribly wise to have 40% of your money at risk. If markets correct or crash and we enter bear-market territory, your total losses could amount to 15% to 20% or more (despite having a relatively small percentage in stocks) – a decline most retirees cannot tolerate.

I would suggest a different course of action to determine the amount of risk you assume (your stock allocation) during extreme markets. If you use some traditional valuation metrics, most notably, the CAPE ratio, combined with your own understanding of investor behavior, you can probably make a pretty good determination as to how much risk you should have in your portfolio at any given time. Right now, for example, in early 2015, we can check off most of the items that characterize bubbles (rapidly rising prices, optimism, easy money policies and historically low interest rates) and the CAPE ratio reads 27. This is a level that indicates we are only, perhaps, 10% away from another 2-sigma event that we can easily define as a bubble. Unfortunately at the present time, I also believe we are in the middle of a fixed-income bubble which means that if you lower your stock or real estate allocation, there are very few conservative alternatives that will give you any sort of decent cash flow or growth potential – you may have to keep the

balance of your portfolio in short-term bonds and cash for safety and simply wait for better opportunities and valuations.

So, given the fact that we are nearing a bubble, you may decide to begin to reduce your stock allocation. If you typically have 70% of your portfolio at risk in stocks, you may start by decreasing it to 50%, and if prices increase even further you can sell more holdings. Some would argue to never completely sell out of a stock portfolio, but I disagree. If stock valuations get to levels that clearly aren't justified, then I don't want any of my money at risk and I don't understand why it would be acceptable to just lose "a little" money if you can avoid it. Sure, avoiding losses can be impossible at times, especially if prices are moving rapidly and the market becomes illiquid, but my point is that I see no reason why you wouldn't want to protect ALL your money, as best you can, if it is warranted (you are nearly 100% certain that we are in a bubble).

Another alternative to outright liquidation of equities to reduce risk as a bubble inflates is to reduce risk in a different way. If you typically own index funds or invest in actively managed accounts or mutual funds, the beta of your stock portfolio (measure of the volatility of your portfolio relative to the market itself) is probably very similar to the market itself. So, if the market declines 10%, your stock portfolio will also probably decline by 10%. But, you can potentially reduce the amount your portfolio loses by shifting to a low-beta (low-volatility) portfolio as valuations and risks rise. There are many mutual funds and ETFs (exchange-traded funds) that focus on low-beta stocks although my preference is to create my own portfolio of low-beta dividend stocks for my clients. So, if you reduce the beta on your portfolio, to 0.60, for example, your portfolio should decline by about 60% of the market's decline, if you get caught in a downturn. The defensive-minded investor, interested in

controlling risk, would be wise to reduce beta in the late stages of a bull market and most certainly in bubbles.

My preference, when markets are highly priced beyond levels that can be easily justified, is to not only reduce beta, but to also reduce the overall stock allocation at the same time. So, I'm lowering risk by selling stocks and I'm also lowering risk by having the remaining stocks in the portfolio comprised of low-beta names – adding an additional layer of risk control.

Obviously market timing is very difficult and you will never sell at the top and buy at the bottom and that really isn't a reasonable goal. The idea is to control risk incrementally and to pay attention to your portfolio and the risks you are assuming at all times. So, since you are watching for periods of extreme valuations (high or low) and you are also aware of the other characteristics of bubbles that may occur at extremes, you should alter your portfolio accordingly. As a bubble inflates, reduce risk and as a bear market takes hold, or worse, prices crash, you will have ammunition (cash) to deploy when others don't.

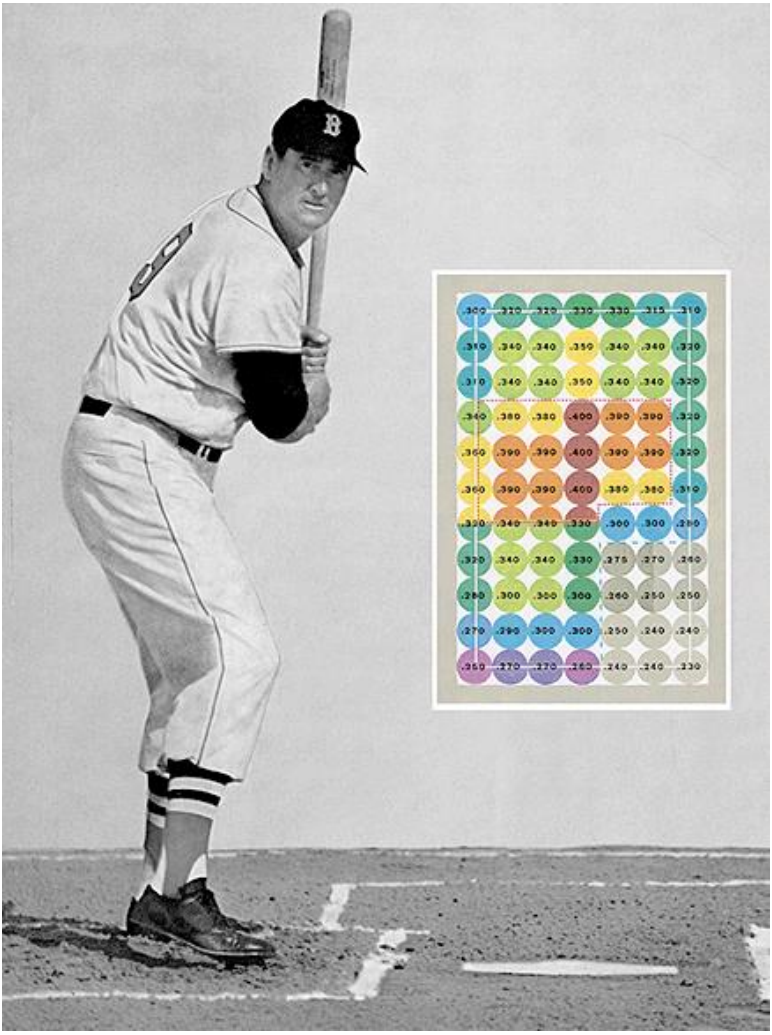
Patience

I can't stress enough how important it is to be patient during market bubbles as they build and inflate further than you ever imagined. This can be quite frustrating as you raise cash during elevated valuation periods only to see the market continue to move higher, without all of your money capturing the additional gains. Rational, astute investors and managers know they cannot adjust a portfolio with perfect timing so don't have that as one of your goals. And, if the market passes you by or simply doesn't cooperate and come down to levels where you see value, then don't chase it. At a certain point in a market's cycle, usually close to an extreme valuation, it absolutely pays to be patient and stick to your plan of risk reduction by selling assets that have greatly appreciated. Eventually prices will move back towards

the mean and offer you a better opportunity to invest and profit, with less risk too.

When a bear market hits, the action can be extremely volatile and frightening – losses can pile up quickly. However, as prices decline to attractive levels, the only investors able to take advantage of the bargains are those who raised cash during the uptrend. If they didn't raise cash on the way up and they are caught in the downturn, they are more likely to only be thinking about selling and trying to capture whatever profits remain – they are not entertaining the thought of buying more stocks. This is unfortunate.

Ted Williams, the legendary baseball player who some argue was the greatest hitter ever, reduced hitting to a science. He broke the strike zone into smaller zones and knew exactly where he would be more successful if he swung at a pitch. He knew that if he waited for a pitch in his "happy zone" he would likely be successful by squaring the bat up to the ball and hitting it hard (and he did that a lot). For pitches outside his zone, he simply didn't swing at them – he was patient. Investors can learn a lot from the patient hitting approach adopted by Ted Williams and apply it to investing. At times, and specifically when markets are clearly overpriced, be patient and wait for your pitch.



13

Managing your expectations

If you can count on anything in investing, it's consistent dividend growth from quality companies. Capital gains may not materialize.

WHEN I MEET WITH PROSPECTIVE CLIENTS I tell them not to expect anything, as far as annual returns, beyond what the portfolio's cash flow provides after fees. With a fully-invested portfolio of high-quality dividend payers in today's environment, this equates to net cash flow of 2.5% to 3.0% annually. I tell investors that although this percentage is not guaranteed (some companies do occasionally reduce or eliminate dividends), if one chooses well, the dividends will increase every year. There are plenty of quality stocks to choose from that have maintained or increased dividends over the past 25 years or more. So, while the cash flow of a fully-invested portfolio should be consistent and grow over time, capital gains in any given year are unknowable. Sure, if all goes well and the portfolio is positioned correctly and markets are bullish, you may well capture a nice large capital gain too. In fact, the capital gain may well dwarf your cash flow making for an excellent total return after factoring in dividends and capital growth. But, recognize that the capital gain part of

the equation is unknowable and inconsistent, so it should never be expected.

If an expected annual return of 2.5% to 3.0% seems meager to you, it's because it is, and history would suggest that average returns should be much higher. Still, the reason I tell investors not to expect more is to keep their expectations in check. Investors should be aware that because of the cyclical nature of markets, there will be years when returns are negative and there will be years with healthy gains, but cash flow should be fairly consistent.

During normal market valuation periods I believe it is reasonable to expect returns in the single-digits, a few percentage points above inflation, and occasionally in low double-digits if one's starting valuation point is attractive. But, there are also times when even low single-digit returns look unlikely and if you are expecting more, you could be disappointed. And, I don't think it is a good idea for a money manager to assume more risk in an effort to meet a client's high expected returns because the added risk will more than likely backfire. In certain markets you just can't squeeze that much out of a portfolio, as far as gains, while maintaining a defensive-minded approach. Therefore, it's important for rational investors to not only pursue, but expect realistic returns. If markets are fully valued or overvalued, it's equally important to recognize that flat or negative returns could persist for some years. Much depends on one's starting point.

What is the optimal starting point for investing? Well, most of us don't simply start investing all at once. Most of us start at a relatively young age and over the course of a lifetime add to a portfolio as we save and have excess reserves to invest. But, let's assume you rolled over a lump-sum at age 65 and have the entire amount to invest – you rolled all the proceeds and it's sitting in cash in your IRA Rollover. If I were advising you and we were

discussing your expected returns, I wouldn't want you to anticipate more than the net cash flow of the portfolio in any given year. And, if markets were overvalued when you started investing and we retained some cash or low-yielding bonds for safety, the cash flow could be minimal and capital gains unlikely. On the other hand, if the market was depressed with below-average valuations, I would anticipate that returns might actually be better than average going forward. So, it all depends on where we are in the cycle and what projected returns look like based on historical valuations.

Legendary investment manager Jeremy Grantham wrote a timely investment piece back in March 2009 when many thought the financial system was collapsing. Stocks had dropped 50% and portfolios were at least temporarily wiped out. The article was titled *Reinvesting When Terrified* and it offered invaluable advice. Assuming one had cash available, and it was March 2009, Mr. Grantham's advice was to overcome "terminal paralysis" by investing in several steps. Since it is impossible to pick the bottom and it is indeed easy to be paralyzed (parting with cash in bear markets is psychologically difficult) and not act, if you invest several tranches at various times, it is more palatable. Mr. Grantham also suggested you should not only have a battle plan for reinvestment and to stick to it, but also a definition as to what it would take for you to get fully invested. Without a plan – one that you will follow – you will be lost.

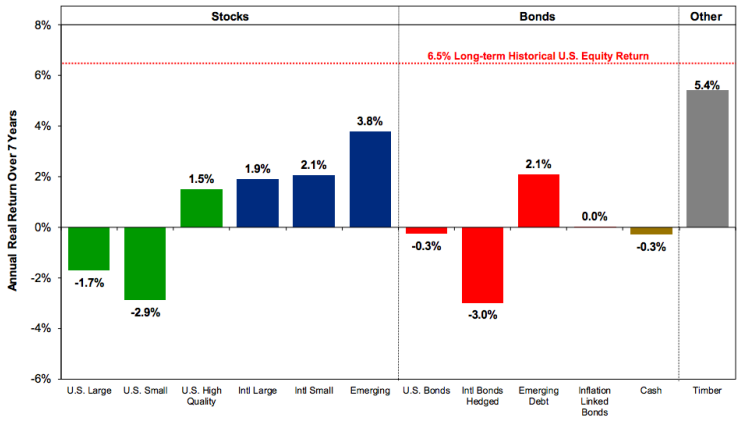
Mr. Grantham's point is simply that if you have a plan of reinvesting during market declines or crashes and a similar plan to divest during strong bull markets and bubbles you will not only improve your overall return immensely and control risk, you will also have an idea as to how much you can expect as far as total return if you are patient. When Mr. Grantham wrote his article urging investors to reinvest in March 2009, the CAPE ratio was below 14 and future returns looked quite promising.

Unfortunately, with the current CAPE ratio at 27, which is well above the historical average of 16.5, one should expect below average or even negative returns over the coming years. Yes, if you stay invested you can expect the cash flow from your portfolio, but nothing more. If you look at the *GMO 7-Year Asset Class Real Return Forecast* done at the end of Q3 2014, you can see why it is incredibly important at this time to manage your return expectations. Given the unusually lofty valuations of all asset classes, GMO predicts average annual returns to be very low or even negative, after inflation, for most asset classes. GMO has a great track record and its sobering forecast should convince you to temper your expectations.

In summary, regardless of valuations and where we are in any bull or bear-market cycle, my suggestion is to keep your return expectations reasonable and never expect more than the net cash flow your portfolio generates. Keep your expectations in check, withdrawals moderate (cut spending if necessary in tough markets), and you should have an excellent chance of achieving lifelong returns that are healthy enough to provide you with a financially comfortable retirement.

GMO 7-Year Asset Class Real Return Forecasts*

As of October 31, 2014



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