Life Boat Drills

Or

Why it's tough for humans to be successful investors

> ***"It may not feel like it, but 2012 has been the greatest year in the history of the world. That sounds like an extravagant claim, but it is borne out by the evidence. Never has there been less hunger, less disease or more prosperity. The West remains in the economic doldrums, but most developing countries are charging ahead, and people are being lifted out of poverty at the fastest rate ever recorded...We are living in a golden age."***
>
> **— "Why 2012 Was the Best Year Ever," *The London Spectator*, December 15, 2012**

The election. The fiscal cliff. The national debt. The federal deficit. Slow economic growth. High unemployment. Superstorm Sandy. The double whammy of ObamaCare tax increases and expiring George Bush tax-cuts. The demise of the Euro. Federal Reserve printing money. The slowdown in China. The LIBOR scandal. The Facebook IPO flop. What a list of doom and gloom that 2012 faced!

Yet something very odd happened. The stock market failed to get the message. The S&P500 ended 2012 at 1667, an increase of 13.4%. And the more popularly followed Dow Jones Industrial Average ended 2012 at 13,104. The pessimists were foiled again.

And the beat goes on. The equity indexes continued through the late winter into spring climbing the proverbial "wall of worry" recording new all-time-highs. Dow 13,000. Dow 14,000! Dow 15,000!! As the market mood shifted from fear to greed, it was inevitable that my phone would begin to ring with questions regarding under-performance. A sure sign that we are nearing a market phenomenon known as the "CORRECTION."

If history is to be our guide – and it is the only rational guide I know -- most years witness at least one period when the equity indexes drop 10-15%, referenced above as the "correction." No big deal you say? A pro like you can handle a small correction on the road to long-term riches...successful investing is a marathon, not a sprint...don't worry about me, I'm in it for the long haul... etc. etc.

Surviving a correction without doing something you will later regret is not as easy as you think, especially when you have thousands of years of biology working against you. Although we like to think of ourselves as independent-minded individuals who can rise above the crowd, the truth is we find comfort in the herd. Our oldest ancestor on the human family tree is a creature known to scientists as Ardi.

Ardi's fossil remains were discovered in the early 1990s in the Afar desert of Ethiopia. Her remains are estimated to be 4.4 million years old. About 200,000 years ago Ardi's clan evolved into our species, Homo sapiens, a process that took over 4 million years. We developed language and music about 50,000 years ago—relatively recently in our species' history. We began living in settled communities about 15,000 years ago. Our earliest writings are less than 5,000 years old. We developed probability theory and utility theory—cornerstones of investment theory—less than 400 years ago.

"Penetrating so many secrets, we cease to believe in the unknowable. But there it sits nevertheless, calmly licking its chops." -- H.L. Mencken

Our brains evolved to meet the demands of a world that was very different from the one in which we now live. Ardi's brain was 400 grams in weight. Our brains weigh 1,400 grams today. If you start the clock when Ardi walked the earth, we have been "civilized" for only .33% of our existence. We have been writing things down for only .12% of our existence. We have been calculating risk for only .006% of our existence. Even as our brains grew to three times the size of Ardi's, for most of our history we have been primarily concerned simply with survival.

Sticking with the herd has ensured survival since we first started our evolutionary march. Those who wandered too far from the group became a snack for the predators which far outnumbered our distant ancestors. Even when the balance of power between predators and humans turned in our favor, sticking with the herd improved our chances of survival. Loners were easy pickings for hostile tribes. There was strength in togetherness.

Although herding has helped ensure our survival for millions of years and is rewarding psychologically and even physiologically, it can be harmful to us as investors. Legendary investor, Warren Buffett, says it best: "Be fearful when others are greedy and greedy when others are fearful." In other words, do exactly the opposite of what the herd is doing. This is a lesson that has been taught over and over, from the Dutch tulip mania of the 17th century to the tech bubble of the 21st century.

Taking a stand that separates you from the crowd is very hard to do. It requires you to swim upstream against millions of years of conditioning. We are wired to believe that our safety and even our survival depend on staying with the larger group. Striking out on our own feels very uncomfortable.

It is even harder these days because the voice of the crowd is amplified through the media. Perpetual processions of punditry tell us what the future will hold and what we *must* do to survive it. They are well-credentialed, well-dressed, well-spoken and full of confidence. Their gravity draws you in.

Yet those who have studied the forecasts of the futurists and the predictions of the punditry tell us that very often they are just plain wrong. *Future Babble* by Dan Garner, *The Signal and the Noise* by Nate Silver and *Expert Political Judgment* by Professor Philip E. Tetlock all document the shockingly poor performance of those who would tell us what the future holds. Indeed, Tetlock's studies reveal that the more well-known a prognosticator is, the poorer his or her predictions about the future are likely to be. He found that, as a group, experts are less accurate in their predications than a room full of "dart-throwing monkeys." As Nobel Prize winning physicist, Niels Bohr, said (channeling his inner Yogi Berra): "Prediction is very difficult, especially about the future."

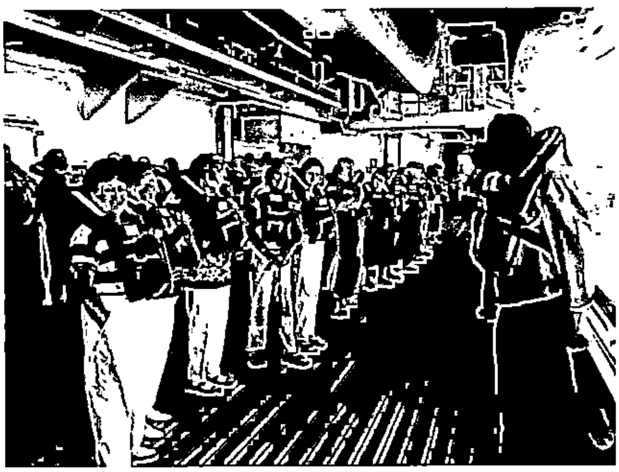
One of the principal functions of my job as an advisor is to help clients resist the herd-following urges that have been engrained over the centuries and close your ears to the Sirens song of the experts/entertainers. Sometimes we must follow the road less traveled and act based on what we can see, measure and truly know, not upon guesses and speculations about the future. There are simply too many variables that determine how events will unfold to be sure of anything.

Thus, to prepare us for the "correction," we interrupt this correspondence to provide a MANDATORY LIFE BOAT DRILL—

Sharpen your Ticonderoga and prepare for some very simple math. LIFE BOAT DRILLS require that you actually do the math:

5/17/2013 closing price of Dow Jones Industrial Index =	15,354
Possible sell-off in equity prices	X .15
15% of 15,354 =	2,303
Which results in a Dow Index of	13,051

Dow drops 2300 points to 13,000. Say that out loud two times...Dow drops 2300 points to 13,000...Dow drops 2300 points to 13,000. Now imagine for a moment the utter enthusiasm and excitement in the studios of CNBC and Bloomberg. The champagne and balloons will be out of view of the folks at home, but bad news is good news for the apocalypse du jour crowd.



Is this a market forecast? Am I predicting a 2300 point sell-off? Of course not. There is no investing system clairvoyant enough to know the direction of the stock market on any given day, week, month or year. No one knows, with certainty, the time or the day of the correction. It will arrive as unexpectedly as it will disappear. And then, the beat will go on.

So what am I suggesting? For most of you, nothing – absolutely nothing. If you have been working with me for several years, and we have been meeting or talking at least annually, then your asset allocation should be appropriate for your age, cash flow and liquidity needs. If it has been a long time since we have had a nice chat, then call the office right now and talk with Jeanne to arrange a meeting. Let's make sure you have had your Life Boat Drill.

That is the purpose of lifeboat drills, to prepare you to take NO ACTION. To fight the biologically human urge to follow the herd, and hide away in a cave of cash. Markets have corrections, and Life Boat Drills train you to take the appropriate action...which is...sit tight...enjoy the end-of-the-world banter throughout the media...and then prepare dinner. In other words, absolutely nothing.

> "In almost every activity of normal life people try to go where the outlook is best. You look for a job in an industry with a good future, or build a factory where the prospects are best. But my contention is if you're selecting publicly traded investments, you have to do the opposite. You're trying to buy a share at the lowest possible price in relation to what the corporation is worth. And there's only one reason a share goes to a bargain price – because other people are selling. There is no other reason. To get a bargain price, you've got to look for where the public is most frightened and pessimistic."
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> *-Sir John Templeton*

Memorial Day is this weekend. Can you believe it? Enjoy the summer.

And for those of you that insist I make some type of forecast – here it is -- Cornell wins the National Lacrosse Championship in Philadelphia on Memorial Day. Remember, you heard it here first.

John Bodnar, CFP®, CIMA®

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