Miracle Mile ADVISORS

Providing Global Opportunities for the Risk-Aware Investor

Do You Want to Be Right, or Do You Want to Be Rich?

Every day of our lives we face an endless stream of choices. Some decisions are made with barely a thought, like how many sugars to put in your coffee. Some take a bit more analysis, like which route home from work will be quicker today. There are standard, reflexive answers for these decisions – you know the surface streets are *usually* faster than the freeway. But what about the day you discover a new construction project halfway between your home and office? Most of us would check traffic on alternate routes and take a detour. We know that we must be adaptive in our decision making, not blindly follow the default action and hope that the situation corrects itself. Idling in the line of traffic but believing strongly that the crane should not be going up in the middle of Wilshire Boulevard does not change the fact that it is taking up two lanes of traffic and raising your blood pressure. Eventually regular commuters will accept that the construction is here to stay (stimulus projects!) and make more permanent adjustments to traffic patterns; but in the interim, nimble drivers can make pretty good time.

In the current equity market rally, the driver idling in line, thinking the crane is a bad idea, is the one whose portfolio is primarily in cash – standing still, burning gas, and wishing the whole thing would just hurry up and go away. He believes he is right, and in time he will be vindicated. At the other end of the spectrum is the motorcycle weaving wildly between lanes of traffic – the investor who saw a big opportunity and gunned it early in the rally. Make up for lost time and money, regardless of how dangerous the journey. In between is the nimble driver who finds an alternate route, one that allows her to reach her destination faster than idling, but more safely than zipping between cars.

The dichotomy of feeling cautious given the economic fundamentals, yet wanting to participate in the equity rally, has defined much of 2009. In this month's piece, we boil it down to this: ***"Do you want to be right, or do you want to be rich?"*** We believe that the answer to that question currently delineates the two main forces in the equity market – those who firmly believe in or against a fundamental case, and those who are motivated by making up for the losses of 2008. The two camps consist of groups with different motivations, but do overlap somewhat. Below we give what we believe is the prevailing answer to this question for many of the players, and how their differing objectives and subsequent actions could affect the path of the markets in the days and months to come. We believe that Miracle Mile Advisors' clients should have a foot in both camps – be nimble and take an alternate route, which is a diversified, risk-aware portfolio that participates in the upside but protects on the downside.

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Economists: *"Right"*

Economists have taken a lot of flack during the last several years – at first they didn't accurately predict how bad the downturn would be; once it was here they became overly-pessimistic; and then they underestimated the nascent recovery. Admittedly not a great track record, but it is important to understand the role of the economist when heeding their forecasts. First and foremost, the economy is not the market. The real economy is the data, while the market trades on expectations. In economic terms, GDP growth of 3% is GDP growth of 3%, plain and simple. In the investment world, a report of 3% GDP can spark a rally if only 2.8% was expected, or a sell-off if the forecast was for 3.1%. The sources of growth could also affect market behavior.

There is a vast crevasse between academia and Wall Street. In our June research piece, *"Market Therapy,"* we discussed some of the ideas of *behavioral finance*. This camp believes that markets do not behave rationally, and may be driven in part by human emotions. Investors know that markets overshoot "fair values" on both the upside and the downside, usually driven by swings between greed and fear. These periods of disequilibrium are difficult to model from a theoretical perspective, but can make up years of an investing career. It is unrealistic to think that investors will just sit by when there is clearly money to be made during these times. Based on a factual analysis of the prospects for consumers, housing, employment and the still-illiquid lending markets, the S&P 500 probably "shouldn't" be up more than 50% from its March low, or maybe it should never have descended that far in the first place. Investors have made money this year in not just equities, but also bonds, commodities, and inflation and dollar hedges. Why is that? It is largely because there has been a return of willingness to take risk, and a reversal of the overshoots that resulted from the extreme risk aversion of late 2008-early 2009. A diversified portfolio of moderately risk-bearing assets is more attractive than cash under these circumstances.

The Government: *"Rich"*

It comes as no surprise that it is in an administration's best interest to keep the economy from falling off a cliff, especially one with a first term president who hopes to be reelected. As we discussed above, however, the economy is not the market. Regardless, the health of the stock market has a huge impact on consumer confidence, spending patterns, and government outlays. The stimulus measures introduced earlier this year were imperative to keep both the economy and the market on life support. Some argue that the bail outs introduced moral hazard and that the at-risk banks and auto makers should have been allowed to fail, but there was virtually no chance that would be allowed to happen. From a purely "right" point of view, allowing these firms to disappear would have been the quickest path to unwinding the bubble and deleveraging. Not allowing this to happen put the government clearly into the "rich" category. It seems unlikely that the government will unplug its lifeline as long as a longer-term recovery is at risk. In fact, talk of a second

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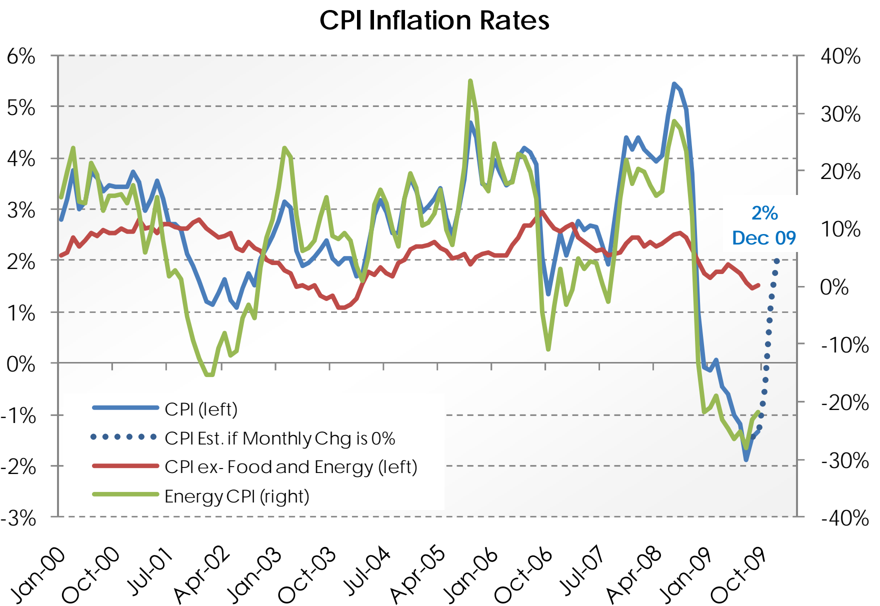
broad stimulus package has surfaced amidst fears of a double dip, in addition to one-off injections like extended unemployment benefits and a continuation of the first-time buyer home credit. "You can't fight the government" has become a new investment mantra, and we think a serious risk to anyone considering shorting the equity market.

The Fed: *"Rich" but "Right Enough"*

The Greenspan Fed has been widely criticized for enabling, if not creating, the credit/housing bubble we are now deflating. Prolonged, extremely-low real interest rates and easy credit provided the grease for an overleveraged and excessively-housed American consumer. The blind belief that the free market is self-correcting and will limit dangerous excesses has taken a hit, and is no longer in vogue at the Fed. We believe, though, that the Fed is willing to err on the side of over stimulating (dovish stance) rather than anticipate and fight inflationary pressures (hawkish stance). The Fed is aligned with the administration in its desire to keep stimulus in place long enough to make sure we do not double dip. Given the lags inherent in policy responses, however, it is likely that by the time the Fed starts to tighten policy, remove liquidity and raise interest rates, inflation may already be upon us. We think that is why most Fed officials continue to talk down any signs of inflation, quieting calls for withdrawing liquidity. The Fed by law has a three-prong mandate: to pursue stable prices, maximum employment, and moderate long-term interest rates. It most certainly wants and needs to adhere to its mandate of price stability; however, we think in the short run, it is placing a solid recovery (employment) ahead of the others.

Despite concerns of pervasive deflation on the back of plummeting real estate values and a weak job market, this phenomenon never emerged. Expectations during Q4 2008 for a very deep global recession drove down commodity prices, especially oil, suppressing the inflation rate. Since the extreme fear has subsided, we have seen a jump in oil and commodity prices. When we hit the year-on-year comparisons in October from last year's suppressed rates, we will see a significant jump in the CPI and Energy CPI numbers. The dotted blue line on the graph simulates that even if we post 0% monthly inflation rates for the next three months, broad CPI will be running at 2% by the end of the year.



Source: Bureau of Labor Statistics

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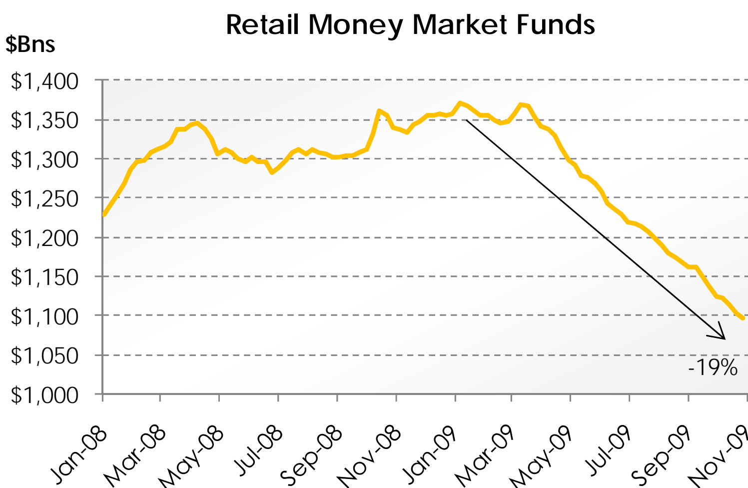
Globally, central banks in Asia are anticipating raising rates to fight inflation and curb consumer demand. While the Reserve Bank of India did not lift interest rates at its meeting this week, it began withdrawing monetary stimulus by ordering lenders to keep more money in government bonds to restrict credit flow. Strong consumer demand in emerging countries like China and India could lead to higher commodity prices worldwide igniting inflation in the U.S., particularly in light of a weakening U.S. dollar. South Korea reported its fastest growth in seven years in Q3, buoyed by rising Chinese demand for its exports. A closely-followed trade indicator from the Dutch Bureau for Economic Policy Analysis confirmed the strength of import demand from emerging Asian countries, showing a 6.6% increase in the June–August period. We believe this provides more upside in inflation hedges such as Treasury Inflation Protected Securities and gold.

The American Consumer: *"Rich"*

American consumers had felt rich on the back of increasing home values, easy credit, and investment wealth, even if incomes were stagnant. Clearly, they would like to get that feeling back. It does not look like that will happen in the near future from wage growth, nor from home values or borrowing. That leaves investment wealth. As the market climbs higher, we have seen an ever-increasing willingness to jump into equities. Even conservative investors cannot help feeling left behind as they fight the urge to "make up" for last year's losses. It is important to invest according to your risk tolerance, regardless of the level of the Dow. Unless you are an ultra-conservative investor, then having diversified exposure to equities is probably the right thing to do, as long as you can tolerate some volatility. Whatever your risk profile, "doubling down" on risk at these levels is likely not in line with your tolerance. The momentum of crowd mentality can be a very powerful force.



Source: Investment Company Institute

Another incentive for Americans to reinvest in risk-bearing assets is the near-zero rate on cash equivalents. With even a negligible rate of inflation, and fees, this yields a negative return. The buy-on-dips philosophy has returned somewhat, as investors have put to work some of the cash idling on the sidelines. Retail money market funds have seen outflows of $262 billion this year, through October 28th. This may be a sign that retail investors are getting comfortable again with accepting additional risk for more potential return.

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China: *"Rich"*

As we discussed in last month's piece, *"The 800 Pound Gorilla,"* China is quickly emerging as a prominent player on the global stage. Its economy has grown through exports to developed nations, and now the government has its sights set on building more robust domestic demand and moving away from its dependence on the consumers of the U.S. and Europe. China has turned the global recession into an opportunity to use directed stimulus measures to improve and build infrastructure to support its emerging middle class society. Its third quarter GDP growth just came in at 8.9%, two-to-three times the growth we will likely see in the developed world. As this economy matures and the Chinese grow wealth, we expect to see a shift in the ratio of industrial to service-based output. According to the CIA World Factbook, in 2008 the split was about 40% service-based to almost 49% industrial, with the remainder in agriculture. This contrasts with developed regions like the European Union where services account for 71% of output, and the U.S. where it reaches nearly 80%. We believe that emerging economies will continue to post superior economic growth and equity market returns in the quarters to come.

The U.S. remains somewhat vulnerable to China, and vice versa, as the largest foreign holder of Treasury bonds and dollars. For the time being, it is in China's best interest to support dollar strength. Recently, however, Chinese officials have been throwing their weight around with comments suggesting that they should cut dollar holdings, and questioning the dollar's status as global reserve currency. We doubt that in the short term the dollar's primary status is at risk, but given the massive deficits in the U.S. and the Treasury issuance required to fund them, we expect the dollar to remain under pressure for the foreseeable future.

Hedge Funds: *"Rich"*

In general, the widely accepted 2-and-20 hedge fund pricing structure (2% management fee, 20% of profits) incentivizes managers to shoot for the moon. Many funds institute a "high-water mark" structure, meaning that the 20% performance fee kicks in only after the fund reaches the highest net asset value it has previously achieved. After a dismal 2008, many hedge funds have rebounded this year and are close to, if not above, their previous high-water marks. These managers could decide to dial down risk and take gains to lock in levels guaranteed to generate performance fees this year. Given the diverse strategies they employ, however, and their ability to go long or short and use leverage, it is difficult to estimate what could be the overall impact on the markets.

	Hedge Funds[1]	Mutual Funds[2]	ETF's[3]
Assets	$1.5 trillion	$20.3 trillion	$933.5 billion
# of Funds	8,195	66,472	1,819

[1] *Assets as of Sept. 2009, Hedge Fund Research; Funds as of Oct. 2009, Morningstar Altvest*

[2] *Worldwide mutual funds, as of Q2 2009, Investment Company Institute*

[3] *As of Q3 2009, Barclays "ETF Landscape"*

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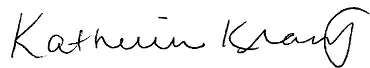
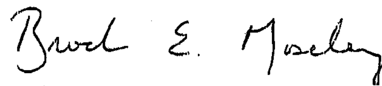
Miracle Mile Advisors: ***"Right" About Risk, "Rich" For the Long Run***

We spend a lot of time thinking and talking about the economic fundamentals, but first and foremost we are investors. Our goal is not to correctly forecast GDP or employment, but to manage our clients' portfolios within their tolerance for risk. Sometimes the markets react in an unpredictable way to data or other events, especially when momentum – either positive or negative – takes over. It is impossible to predict and manage to the day to day movements of the markets – despite the media's attempts to do so – and getting caught up in that mentality can cause investors to make foolish moves. We think it is essential to remember that even for someone who experienced significant losses last year, or has not participated this year, going beyond one's risk tolerance to try to "catch up" only puts more wealth in jeopardy. This does not mean that an investor should never change his or her risk exposure, just that it should be dictated by personal tolerance and not market momentum. We as advisors make strategic and tactical moves in our clients' portfolios to dial risk up or down in order to keep the return/risk trade off consistent.

We strive to preserve and grow the wealth of our clients. We are the nimble driver looking for a safe, alternate route around the obstacles. We may not get home as quickly as the motorcyclist on most days, but it is far more likely we will reach our destination safely.

October 30, 2009





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