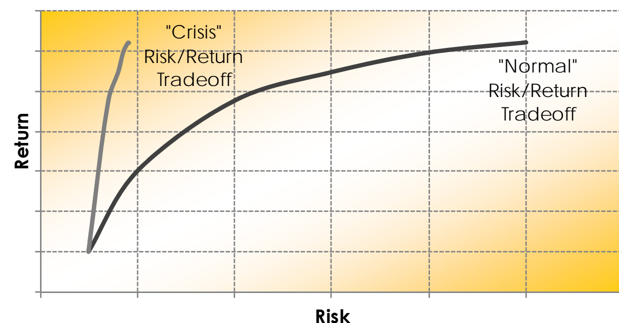
At their core, the markets are an experiment in human decision making. From the micro-level strategy decisions made by companies' managements to the macro-level policies of governments and central banks, it is impossible to completely separate the subjective from the hard data. Expectations rule the financial markets, even in good times. We routinely see a stock punished for a record-earnings report that came in a penny or two below "expectations", and conversely we have seen the market rally on an unemployment rate jumping by "only" 0.3% instead of 0.5%. Recently, market psychology has played a very prominent role, and we have learned a valuable lesson as to the power of risk aversion. In the last twelve months the beating an asset took in the marketplace seemed to increase at an exponential rate with its perceived risk. Even with a 0% nominal yield, short-term Treasury bonds were a powerful magnet for investors, while spreads on bonds just slightly farther out on the risk curve widened dramatically.

Quantitatively-driven hedge funds have blown up, long-term trends have not reverted to the mean, and greed is not good. Investors are faced with two Darwinian options: adapt or die. In an environment where the markets are often trading on emotion, the question presents itself: *how do we use the current market psychology to our advantage to provide our clients with the best possible risk-reward tradeoff?*

All Pain, No Gain

Research has shown that risk assessments made under "normal" conditions and those made under extreme uncertainty stimulate different regions of the brain. "Normal" decisions pique the reward-prediction area of the brain, while "stressful" decisions stimulate the area associated with fear and emotion. As Nassim Taleb stated in his book, *Fooled By Randomness*, "Risk detection and risk avoidance are not mediated in the 'thinking' part of the brain but largely in the emotional one…It means that rational thinking has little, very little, to do with risk avoidance."

Now, more than ever, investors are prioritizing risk avoidance. A fundamental principal of investing is that people will demand a higher expected return for a greater level of risk. Under normal conditions, the curve of risk/return tradeoffs has a gentle upward slope. In an environment like today, however, that curve turns nearly vertical as investors refuse to go further out on the risk spectrum regardless of the possible return. The pendulum has swung almost completely away from greed and toward fear.



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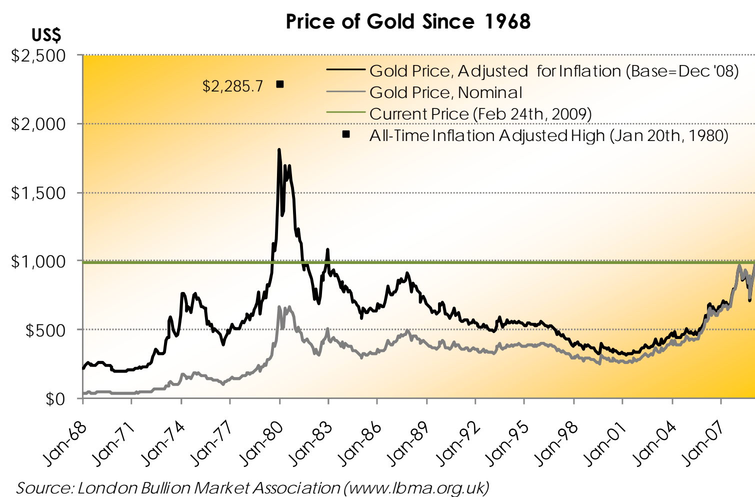
The Trend Is Your Friend

One of the phenomena we witness in times of frenzy, both positive and negative, is momentum investing. During the technology bubble in the late 1990's, people from every facet of society piled into dom.com stocks chasing performance as valuations skyrocketed. At the end of 2008 we saw the other side of that coin as investors fled to the safety of short-term Treasurys despite a 0% yield. Taking a contrarian view can often reveal a profitable entry or exit point, but during extremes in sentiment the timing is crucial. We would like to see that the markets have some clarity and confidence in how the banks will be stabilized. Until then, the sections below detail what we are doing to avoid catching a falling knife.

Cash Is King

Certainly not a groundbreaking call, but heavy allocations toward cash and cash-equivalents have helped investors sleep well for the past several quarters. The decision at Miracle Mile Advisors to cut our developed equity holdings to half positions in July 2008 proved very beneficial to our clients. We moved those assets mainly into the iShares Barclays Short-Term Treasury Bond Fund (SHV), and we expect to maintain this tactically-overweight cash/fixed income position for the foreseeable future. Short-term yields have come off their lows, but still provide a negative real yield if inflation remains even slightly above water. We are looking toward shifting some of these assets into other cash-alternatives in anticipation of Treasury yields backing up further.

The Gold Standard



Source: London Bullion Market Association (www.lbma.org.uk)

Gold has had a significant run in the last several months, but we believe it plays an important role in a portfolio. On an inflation-adjusted basis, gold is not even close to its all time high of $2,285 hit in January 1980. Although stories are told of people hoarding gold coins and keeping bricks in their homes, the launch of the SPDR Gold Shares ETF (GLD) in 2004 opened up easy access for private investors. The ETF owns the actual bullion, and GLD is now the largest buyer of physical gold in the marketplace. Its holdings stand at 1,029 tons, having added 220 tons in just the last month. It is now the second largest ETF in terms of assets behind the S&P 500 SPDR.

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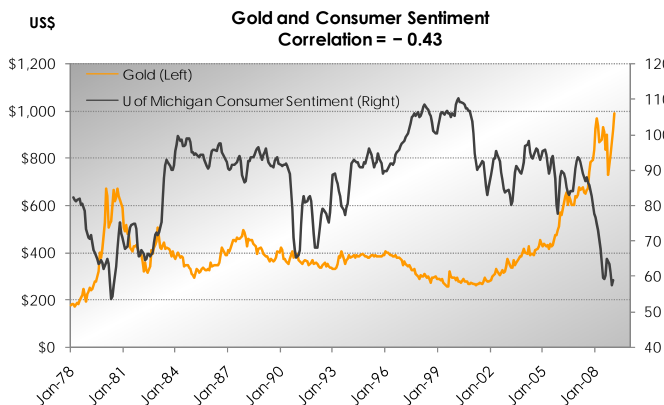
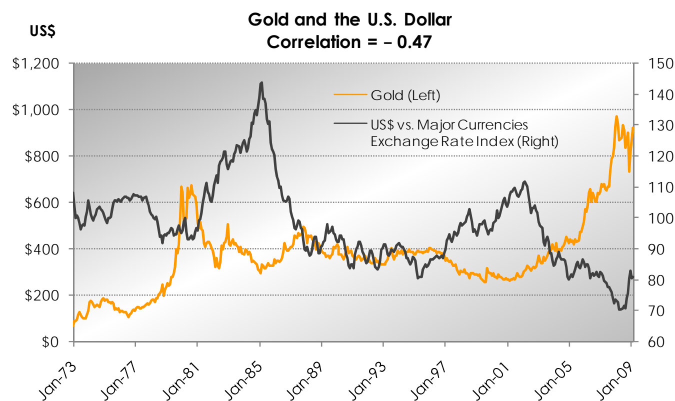
Investors have turned to gold for various reasons throughout financial history, but it usually attracts interest in an inflationary environment. Today, this is not an immediate concern, but we see two other reasons to hold gold. One, it is an anti-fear trade. The graph below, left, shows that over the past 30 years the price of gold and consumer sentiment have exhibited a strong negative relationship. When uncertainty and pessimism rise, gold is a safe haven. Today, investors are taking comfort in owning a physical, tangible asset at a time when valuing more esoteric financial instruments is almost impossible.





The second, and probably more important reason, is that gold plays the role of "alternative currency." Many investors are concerned that the world's major fiat currencies will be devalued as governments print enormous quantities of money to fund stimulus measures. Despite President Obama's pledge to halve the deficit before the end of his first term, it is likely that the overhang from this massive spending will weigh on the dollar for some time to come. In Europe and the U.K. interest rates have further to fall, potentially making their currencies (and bonds) even less attractive. The European Central Bank is behind the curve on easing monetary policy, with rates still at 2% today (the U.S. Fed moved rates to 2% in April 2008), while talk of "quantitative easing" (buying gilts) has just begun in the U.K. The Bank of England recently lowered its policy rate to 1% (the U.S. Fed lowered rates to 1% in October 2008). The Eurozone could also feel the ramifications of growing instability in central Europe. Banks in Poland, Hungary, Romania and the Czech Republic are under pressure from depreciating currencies, which could spill over into Eurozone countries like Austria and Italy where many of the parent banks are based.

We are mindful of the fact that gold has already had a significant run, and continued frenzied buying could be a contrarian indicator. Sentiment for the metal is strongly positive; Market Vane traders' bullish consensus reading for gold recently neared 80%. Osmium Capital Management, a Bermuda-based hedge fund, has even begun offering investors the opportunity to have their investment denominated in gold. The fund launched a new share class in which investors'

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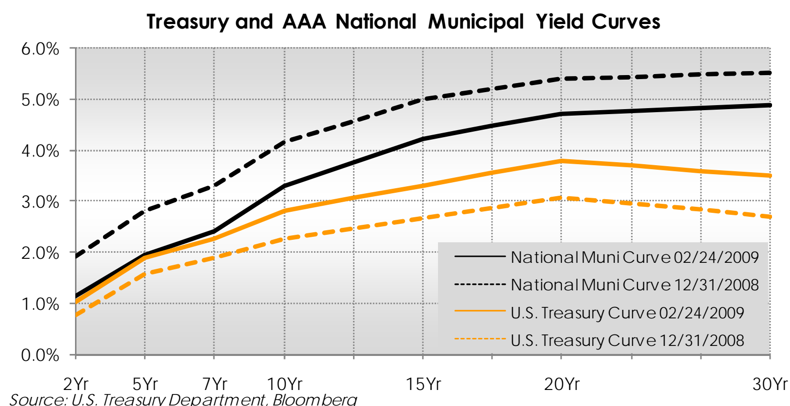
holdings are measured as troy ounces, rather than U.S. dollars, pounds, or euros. Considering the extreme optimism surrounding gold, it is possible that we could see some short-term retrenchment. We believe though that there will be continued support for the metal as long as fear and uncertainty remain predominant in the markets. We hold small positions in the SPDR Gold Shares ETF (GLD) as one of our Alternatives holdings, and also own gold through our diversified commodities ETF positions.

Fixed Income Safe Haven

We believe that an overweight allocation to fixed income remains warranted, but it does not have to be in low-yielding Treasurys. In our December 2008 research publication, "*Fixed Income Mechanics*," we made the case for moving fixed income holdings into the municipal bond market. At that point, short-term Treasurys were yielding near 0%, and yields across the curve were hitting historical lows. If there was one place to move out slightly on the risk curve to pick up some return, we felt it was fixed income. To date, it has proven a positive move.



Source: U.S. Treasury Department, Bloomberg

The dotted lines in the graph at right show the Treasury and National Muni yield curves as of the end of December. Not only was the spread between them wide, but munis were (and still are) yielding more than Treasurys even without making a tax-equivalent adjustment! We believed that it was an opportunity to pick up some higher yielding paper while also possibly reaping some price appreciation in the bonds. Since the end of last year, Treasury yields have moved up as the extreme safe haven buying relented somewhat and muni yields have come in (see the solid lines, above). Investors in National and even California municipals have done well in 2009. The iShares S&P National Municipal Bond ETF (MUB) gained 3.4% year-to-date through February 24th, while the iShares S&P California Municipal Bond ETF (CMF) advanced 3.6%. Conversely, Treasurys have retraced some of their gains from 2008, with the iShares Barclays 7-10 Year Treasury Bond ETF (IEF) losing -3.4% for the same year-to-date period.

We continue to recommend high quality municipal bonds, and expect that Treasury yields will climb further as the government issues more and more debt to fund stimulus spending. Although municipalities will potentially increase yields to attract buyers in the future, we believe that money for states from the Federal

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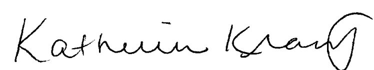
stimulus bill will help limit the size of that yield increase. In addition, we maintain our belief that the longer term risk of default in high quality municipal bonds remains very low. As we noted in our December research piece, even during the Great Depression only 0.5% of all defaulted debt failed to pay back all of its obligations[1]. For California residents, the recent ratification of a state budget provided some reassurance that state monies will be available to meet shorter-term principal and interest payments on municipal bonds. The reality is that the interest and principal payments of California state general obligation bonds effectively have a second lien on all tax revenues of the state, second only to education. In the event of a severe shortfall in tax revenues for the state, we are still confident that the state would be able to make good on its obligations to bondholders.

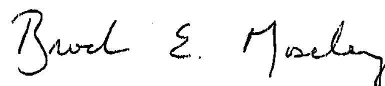
Don't Fight the Tape

Risk aversion still rules the markets, and many investors are trading on emotion. We are not getting paid to take much risk, so for the time being safety is the prudent course of action. As John Maynard Keynes once said, "markets can remain irrational longer than you can remain solvent." The message there is don't fight the tape.

We maintain our holdings in gold, and have higher-than-normal tactical allocations to fixed income and cash equivalents at the detriment of U.S. and international equity. Opportunistically we hold positions in health care, alternative energy and BRIC countries (excluding Russia), which positions us in the areas we believe will generate growth. The markets hate uncertainty, and until there appears to be a concrete plan for stabilizing the banking system and reestablishing credit we will remain cautious of jumping fully into the equity markets.

February 25, 2009





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[1] George H. Hempel, *The Postwar Quality of State and Local Debt*, National Bureau of Economic Research, 1971

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