

# WEEKLY MARKET REVIEW

by Paula Wieck, CLS Portfolio Manager

	Last Week	1QTD	YTD 2012		Last Week	1QTD	YTD 2012
Dow Jones Industrial Average	+1.16%	+5.99%	+5.99%	Barclay's Capital U.S. Aggregate Bond Index	-0.06%	+0.33%	+0.33%
Standard and Poor's 500 Index	+1.38%	+8.24%	+8.24%	Barclay's Capital U.S. Credit Bond Index	+0.04%	+1.54%	+1.54%
NASDAQ Composite	+1.65%	+13.31%	+13.31%	MSCI EAFE International Index	+2.35%	+10.07%	+10.07%

## Market Overview

Market sentiment was mixed last week, but the S&P 500 ended up 1.38 percent and the Dow up 1.16 percent for the week. The S&P and Dow are up 8.24 percent and 5.99 percent, respectively, for the year. Two main focuses last week were Greece and U.S. economic data. Although Greek parliament passed legislation associated with a package of austerity reforms to secure a bailout worth €130 billion from the European Union and the International Monetary Fund, the eurozone's finance ministers postponed its scheduled

meeting on Wednesday in order to buy more time to make a final decision on the bailout. While this negatively-impacted the markets, economic data coming out of the U.S. was fairly positive, which neutralized sentiment.

U.S. retail sales grew less than expected, but core numbers were strong in January, rising 0.4 percent (analysts expected 0.7 percent). Industrial production was unchanged in January, below the 0.7 percent gain forecasted. Markets posted a 1 percent gain on

Thursday as investors welcomed better-than-expected:

- Housing starts (January's .699 million units beat forecasts of .675 million)
- Jobless claims (348,000 compared with the 365,000 forecasted)
- Producer Price Index (PPI) (0.1 percent vs. 0.4 percent predicted)
- Consumer Price Index (CPI) (0.2 percent vs. the 0.3 percent forecasted)

All this news bodes well for equities.

## 2011: A Lesson in Behavioral Finance

Even though we are well into the first quarter of 2012, I'm still frustrated by the markets in 2011. Last year was such a miserable year to manage money – ask any analyst or portfolio manager. With nine different whipsaws back and forth between market rallies and market riots, it was enough to make your head spin. With the

heightened level of volatility and violent intraday swings in market leadership, we felt the pain. We anticipated what the market should do based on fundamental analysis, but the behavior of the markets was much, much different.

In our studies to gain the Chartered Financial Analysts

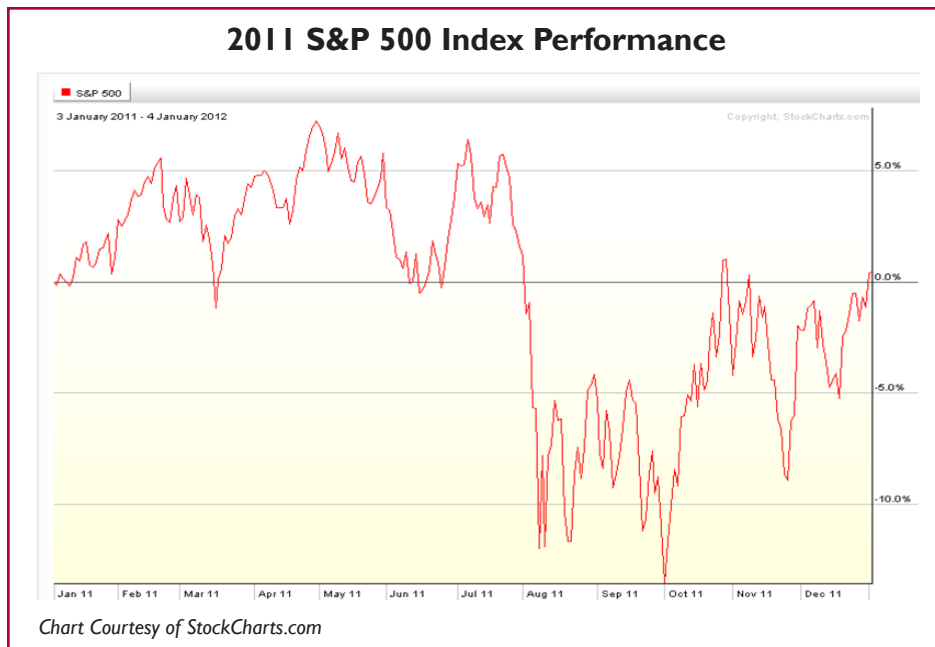
(CFA) designation, we are educated about fundamental analysis, quantitative models, and optimization inputs, as well as behavioral finance. By definition, behavioral finance is the compilation of psychology-based theories to explain stock market anomalies. It recognizes that individuals do not necessarily act

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rationally and consider all available information during the investment decision-making process because they are influenced by behavioral biases, which leads to suboptimal decisions.

The asset classes that dominated performance last year were the safe haven assets: U.S. Treasuries, Gold, and U.S. Large Cap equities, with U.S. Treasuries leading in performance due to investor fears after the debt ceiling debate, followed by the downgrade of the U.S. credit rating in August. The sharp decline in the markets occurred within six trading days after the downgrade! This, coupled with fears that the eurozone's debt crisis would spread financial contagion throughout the global markets, was enough to send investors into a panic, flocking to safety in the third quarter of 2011.

At CLS, we do our own fundamental and technical analysis, but we also seek research from many accredited external sources. The common theme among us last year was that valuations in risk assets were incredibly attractive. Corporate profits were solid in the U.S. and abroad, and emerging economies weren't suffering the same structural headwinds as the developed world. At the time, there was a serious threat in rising interest rates, which implicated that



Treasuries could have had severe downside risks. With the P/E ratio of U.S. Treasuries at 50 compared with Emerging Markets trading at a P/E of around 9 to 10 and the S&P 500 trading at a P/E of about 11 to 12, equities looked good. Emerging markets looked even better. What happened?

This is where our studies in behavioral finance bear fruit. Now, I want to preface this by saying that experts in behavioral finance have yet to come up with a predictive model. While theory doesn't tell us how to beat the market, it does explain to us that irrational markets can cause market prices and fundamental values to diverge for a length of time. How does this help us? If there isn't an enhanced model to help project expected returns, then what's the use, right?

Behavioral finance teaches us discipline. While we are professional money managers, we are indeed human. We felt the pressure to follow the herd. In 2011, we knew that markets didn't make sense, and we were tempted to time the market to give us the potential to make up performance, which is what many individual investors did. This is why we didn't: we are trained to take the emotion out of investing, and we are trained to understand why the market is behaving the way that it is. While we felt the heat to make a change, we had faith in our convictions and held a diversified basket of assets based on fundamental analysis. We didn't time the market because that can lead to dire consequences in these situations. Professional money managers can either choose to follow the fundamentals or ride with the herd and attempt to pick

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the perfect time to exit, knowing full well that fundamentals don't justify the bubble in certain assets.

Years like 2011 are crucial for educating ourselves. Following are some key behavioral biases that led investors to react the way that they did last year and how we worked with clients to see the value in staying disciplined:

- **Regret Aversion** (better known as herding). Herding encourages investors to invest in a similar fashion, which alleviates some of the burden of responsibility, as they feel safer in popular investments. We witnessed this last year, as the herd trampled into over-valued assets such as U.S. Treasuries and gold. Generally, if clients asked us last year to increase their positions in treasuries and gold, we worked with them to see the benefits of diversification and proper asset allocation to reduce risk while keeping their portfolio in line with long-term objectives.
- **Availability Bias** (sometimes called the Recency Effect). Individuals tend to place more weight on recent events than they should. For example, if the price of an asset rises for a period of time (much like treasuries and gold did in 2011),

investors start to believe that they will continue to rise well into the future, causing them to place too much emphasis on small samples that provide an imperfect picture, but that are favored because the information is recently available. The implications are a portfolio that may be too concentrated and hold assets that may not be appropriate. According to a piece by Michael Popmian, CFA, Colin McLean, FSIP, and Alistair Byrne, CFA, for the CFA curriculum, research points to a tendency for individual investors to extrapolate trends and to suffer more from recency bias, whereas many investment professionals expect reversion to the mean.

- **Hindsight Bias.** The belief that the event could have been predicted after it has already occurred. This is one roadblock we encounter as money managers. Most professional money managers will keep a diary of their forecasts and the underlying reasoning behind those forecasts. We then re-evaluate this research after a period of time. This step is crucial in order to reinforce discipline. For example, money managers who invested based off intuition rather than core fundamental and quantitative

analysis would have trouble supporting their rationale if the investment failed. On the contrary, if the investment did well or there was luck in the timing, the manager could wrongly attribute his or her outperformance to exceptional investment skill – better known as *Self Attribution Bias* or *Overconfidence Bias* – leading them to overestimate their knowledge, underestimate risks, and exaggerate their ability to control events.

While behavioral finance doesn't give us any superior prediction model, it does give us a better understanding of how investors and markets behave, and how we as professional money managers can hold ourselves accountable. Last year was a flawless example of how behavioral finance can rear its ugly head into our perfect world of theoretical assumptions and models. Understanding the "why" can encourage us in times when the markets are not acting as they "should," therefore motivating us to hold true to our convictions.

## CLS Protection Fund Update

Representatives: Please log in to [CLSinvest.com](http://CLSinvest.com) to see portfolio positioning targets for the week ending Friday 2/17/12.

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The S&P 500 Index is an unmanaged composite of 500-large capitalization companies. This index is widely used by professional investors as a performance benchmark for large-cap stocks. The Dow Jones Industrial Average (DJIA) is a price weighted index of 30 of the largest, most widely held stocks traded on the New York Stock Exchange. The Nasdaq Composite Index is an index that follows approximately 5000 stocks that trade on the Nasdaq exchange. It is considered a good benchmark for smaller company stocks. The Barclay's Capital U.S. Aggregate Bond Index measures the performance of the total United States investment-grade bond market. The Barclay's Capital U.S. Credit Bond Index measures the performance of investment grade corporate debt and sovereign, supranational, local authority and non U.S. agency bonds that are dollar denominated and have a remaining maturity of greater than or equal to one year. You cannot invest directly in an index. The MSCI EAFE International Index is a composite index which tracks performance of international equity securities in 21 developed countries in Europe, Australasia, and the Far East. You cannot invest directly in an index.

Investing in emerging markets involves greater risk and potential reward than investing in more established markets. Risks for emerging markets include, for instance, risks relating to the relatively smaller size and lesser liquidity of these markets, high inflation rates and adverse political developments.

U.S. Treasuries are short-term debt securities issued by the U.S. government to fund its operations. T-bills usually mature anywhere from one month to one year after they're issued. Instead of making periodic interest payments, T-bills are sold at a discount and rise to their face value at maturity.