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Investment Strategy
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"Cognitive Dissonance"

Cognitive dissonance is the discomfort caused by holding conflicting cognitions (e.g., ideas, beliefs, values, emotional reactions) simultaneously. An example would be – believing that lying is bad (first cognition) and then being forced to lie (second cognition). With that in mind, I like this story by William A. Kent from "The Journal of Personality and Social Psychology:"

> "At two race tracks interviewers questioned 69 horse players on their way TO the $2 window and 72 others on their way FROM the window. The interviewers asked all bettors to rate their chances of winning on a scale of 1 to 10. The result was that the bettors returning from placing their bets had significantly MORE confidence in their choices than those interviewed BEFORE their bets were made. Thus, bettors facing doubts as to whether they had bet on the right horse relieved their tension by believing even more after the fact that they had done the right thing."

From a psychology point of view, the aforementioned quote suggests that in order to reduce the anxiety of decision making, people perceive things in ways that may or may not be logical. Simply stated, people talk the way they bet. From a stock market perspective this means that the interpretation of economic and market news varies in direct relationship to the investor's bullish, bearish, or cautious market position. At the race track if too many participants bet on the same horse, the betting odds on that horse go down. In other words, if the horse is "heavily bet" he becomes the favorite and therefore even if he wins the payout is small. Q.E.D., popularity reduces the reward. Similarly in the stock market if too many participants put their money on the same stock, and it becomes a market favorite, driving the price ever higher, the upside potential is diminished. Hereto, popularity reduces the potential reward. Just listen to what Benjamin Graham has to say about this in his book titled "The Intelligent Investor:"

"The intelligent investor realizes that stocks become more risky, not less, as their prices rise – and less risky, not more, as their prices fall. The intelligent investor dreads a bull market, since it makes stocks more costly to buy. And conversely (so long as you keep enough cash on hand to meet your spending needs) you should welcome a bear market, since it puts stocks back on sale." Graham goes on to note, "The value of any investment is, and always must be, a function of the price you pay for it." This is directly opposed to the Jeremy Siegel school of thought that suggests 7%+ per annum returns over the long-term are a "divine right." My main point is that "cognitive dissonance," once recognized, should probably be bet against. To wit, when everybody bets on the same horse, stock, or market direction, it often pays to go against the crowd. In our business we call this strategy "contrary opinion" investing. While Ben Graham states it much more eloquently, we have often referred to this type of strategy as "buying the flop," except in this case we are not referring to the card game "Texas Hold 'em," but as legendary investor Jim Rogers puts it – *buy panic and sell euphoria*.

Over the past few weeks the economy, and therefore the stock market, has been contemplating "cognitive dissonance" as certain economic readings softened while other strengthened. To wit, it is now well advertised that same-store sales at some of the casual dining restaurants have weakened, as have sales at select department stores. Meanwhile, small fiberglass boat sales were better by 7.8% in June and up a whopping 17.3% for 2Q12. Then there is Harley Davidson (HOG/$43.95/Strong Buy), whose motorcycle sales improved by low double-digits in the same quarter. So, people are not buying food and clothes, but they are purchasing boats and motorcycles?! To me, it's *déjà vu* all over again because this is exactly what has happened for the past two years. Recall, the equity markets have peaked in the May/June timeframe for the past two years and then fallen into double-digit declines on worries of recession. Concurrently, analysts cut their earnings estimates and investors throttled back on stocks. Yet, by the fourth quarter the recession didn't show up, analysts had to raise their earnings estimates, and the stock market rose. I think that is how it is going to play again this year.

Does that mean the current decline, and subsequently range-bound stock market, is behind us? Quite frankly, at this point I don't know. But as repeatedly stated, while I am fairly convinced the June low of 1278.18 on the S&P 500 (SPX/1356.78) was the daily/intermediate-term cycle low, the tape action since then has been spasmodic, leaving the SPX range-bound between the 1280 – 1290 support zone and the 1360 – 1366 overhead resistance zone. Given such choppiness it is difficult to discern any trend either for the "longs" or the "shorts." I did, however, enter last week believing the 1335 – 1345 near-term support level would contain any decline. That resolve was subsequently tested on Thursday with the SPX's close of 1334.76, which is why I stated in Friday morning's verbal strategy comments:

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"So the SPX needs to gather itself together pretty quickly or the equity markets will have lost their collective 'upside mojo' with the implication for the potential of a long and boring summer of a trading range stock market." I went on to conclude, "I really thought there was a good chance the SPX was going to make a decisive/sustained breakout above the 1360 – 1366 zone and blast off to the previous reaction high of 1422. But, unless something positive happens quickly, evidence will mount that the SPX is instead going to waffle for an extended period of time."

From my mouth to God's ears for the "beached whale" became unstuck at JP Morgan (JPM/$36.07/Outperform), our need for some inflation was answered by the higher than expected PPI (+0.1%), the University of Michigan consumer sentiment report was not as bad as feared (+72.0), crude oil rose, rumors swirled about a Chinese stimulus package, and the stock market's focus on "cognitive dissonance" took a decided turn toward the sunny side of the street. The result lifted the D-J Industrial Average (INDU/12777.09) by ~204 points and left me breathing a sigh of relief. That said, until the SPX can decisively break above 1366, and stay there, I continue to think the best strategy is to slowly keep accumulating some of the non-stock market correlated stocks mentioned in these missives. Names for consideration that are favorably rated by our fundamental analysts and have decent dividend yields, include: Allstate (ALL/$33.87/Strong Buy), Covanta (CVA/$17.01/Strong Buy), Johnson & Johnson (JNJ/$68.61/Outperform), Plum Creek Timber (PCL/$40.56/Outperform), Rayonier (RYN/$46.23/Strong Buy), and Stonemor (STON/$26.65/Outperform).

The call for this week: JP Morgan's 17% profit increase served as the *causa proxima* for Friday's Dow Delight because it suggests our banking complex is in better shape than most people think. That's why I told CNBC's Maria Bartiromo late Friday afternoon that the most important earnings to watch in this reporting season are the banking sector's earnings. To reiterate, I think we are going through the same recession "head fake" we have experienced for the past two summers. If correct, when it becomes apparent that no recession is on the horizon, analysts will again have to raise earnings estimates (like they have had to do for the past two years) with a concurrent raise due for the equity markets. As scribed in the recent edition of *The Economist* (as paraphrased):

America's economy is once again reinventing itself. The U.S. economy has repaired [itself] quickly in the last three years. Home prices are among the world's most undervalued (19% below fair value). U.S .banks [are] among the best capitalized in the world. Consumer debt loads are down. Exports are extremely strong. [And] energy, long the U.S.' "Achilles Heel," is now turning into an advantage with the shale gas boom.

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