

## "Thinking About Thinking?"

"Thinking, good thinking that is, is a lonely sport. This may explain why so many of us do it so poorly. Good thinking is also an inefficient process. It takes a lot of thinking to come up with those few good, new ideas that are clearly worth thinking about – ideas that can be exploited in the marketplace. Particularly, as often accurately noted in 1912, 'Most coming events cast their shadow before, and it is on that intelligent speculation must be based.'"

"At the heart of the thinking process is the need to anticipate change correctly, and on a timely basis. Investment thinkers must develop for themselves a model, or systematic perception, as to how markets really work. Those believing strongly in the efficient market hypothesis are, of course, relieved of such undertakings. However, as is becoming increasingly clear, portfolio theory does not fully explain security price movements, either here or abroad, or tell us too much about how to achieve better-than-average performance. Most practitioners of active money management need to improve their thinking procedures."

. . . Arthur Zeikel, "On Thinking" (1988)

I think a lot about thinking in an attempt to improve my ability to make good decisions. I also work hard to avoid linear thinking, which tends to extend present conditions "linearly" into the future. Such thinking caused investors to ignore the Dow Theory "sell signal" of September 1999 with portfolio consequences that are now legend. That same thinking occurred in November of 2007, concurrent with another Dow Theory "sell signal," with similar portfolio consternations. Ladies and gentlemen, economic changes, and for that matter stock market changes, tend to occur on "the margin." That's why one of Jude Wanniski's favorite mantras was, "Individuals who can 'think on the margin' always have an advantage over those who cannot." Regrettably, most of us can't think on the margin, which is why the crowd tends to "move" long after the optimum time to "move" has passed. T. Rowe Price, eponymous founder of the T. Rowe Price organization, said it best, "It is better to be early than late in recognizing the passing of one era, and the waning of old favorites, and the advent of a new era offering new opportunities."

Over my four decades of investment experience I first encountered this "thinking on the margin" concept when the great "garbage market" of the 1960s, where any company whose name ended in "onics" soared, ended . . . and ended VERY badly. Linear thinking, however, kept investors believing the "onics stocks" (read: technology stocks), which were the darlings of the late 1950s into the mid-1960s, would rally forever, ushering in a new era. Indeed, it did usher in a new era as the great bull market of 1949 to 1966 ended with the Dow Jones Industrial Average trading close to 1000 for the first time ever. From there the "onics" stocks crashed, as the leadership "baton" was passed to tangible assets/stocks (read: stuff stocks), spurred by the ensuing inflationary environment.

Come the early 1980s, when legendary investor Dean LeBaron, founder of Batterymarch, was heralded as the originator of indexing and quantitative/computerized investing. Dean was known for demonstrating the ability of – being first, and often early, to investing – where everybody else wasn't. While considered a computerized quant, Dean was prescient in "telling" his computers what macro trends to "play." For example, in 1982 he changed Batterymarch's computers quantitative emphasis from searching for hard-asset investments to investing in financial assets. That insight was huge, and as short-term interest rates fell from 22% to single digits, Batterymarch's performance soared. Clearly, Dean's "thinking on the margin" reaped rewards for investors as he was "Recognizing the passing of one era and the waning of old favorites, and the advent of a new era, offering new opportunities."

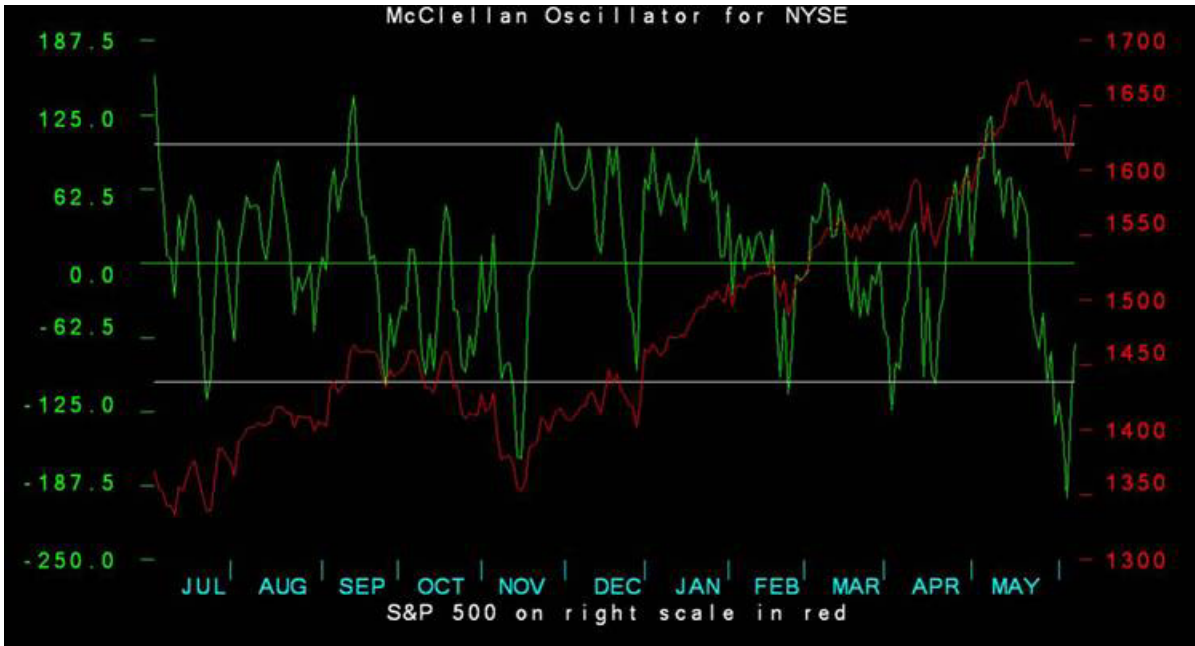
On occasion, I too have "Recognized the passing of one era and the waning of old favorites, and the advent of a new era, offering new opportunities." To wit, in the 4Q01 I gleaned that China was going to join the World Trade Organization, which would cause per capita incomes to rise in China with a concurrent rise in demand for "stuff" (timber, energy, electricity, water, base/precious-metals, agriculture, etc.). That "thinking on the margin" reaped significant profits for those who listened. However, such non-linear thinking, while it occasionally produces net-worth changing ideas, also yields a lot of worthless ones. And, that's why I recommend limiting your losses at 15%.

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Thinking about thinking, what a novel concept, and such thinking left me pondering the odds of a new secular bull market late last year. Having identified the nominal price "low" of March 2009, and the subsequent valuation price low of October 4, 2011, last December I pegged the odds of a new secular bull market at 20% - 25%. I have increased those odds over the past six months to where I now believe those odds are at 45% - 50%, yet few investors believe it. To be sure, most participants think there has to be a "feel good" environment for a secular bull market to exist. The reality is that when that "feel good" environment occurs, you are typically in the late innings of a secular bull market. Ladies and gentlemen, the equity markets do not care about the absolutes of good and bad, but rather if things are getting better or worse; and, things are definitely getting better! In fact, one of my biggest worries is that we get a non-farm payroll report of 300,000, and the unemployment rate drops to 6%, combined with a GDP "print" of 4%.

Nevertheless, I was surprised by last week's 2½-session downside two-step that took the S&P 500 (SPX/1643.38) to its 50-day moving average (@1607) where it found support combined with the most oversold reading I have seen on the NYSE McClellan Oscillator in a long time (see chart on page 3). Subsequently I wrote, "If we rally back toward the recent highs (~1687), and fail to make a higher high, then my mid-July point of vulnerability will regrettably move closer to now. If we do make higher highs, the aforementioned scenario should play." That scenario calls for higher highs into early July; and then, the potential for the first meaningful decline of the year. And make no mistake, if that July/August swoon occurs, I think it will be a swoon for buying, because I believe stocks will be higher by year end.

**The call for this week:** In all of my meetings in Montréal and Toronto last week, every portfolio manager (PM) expressed an interest in increasing their exposure to U.S. equities. That's a trend that began about 18-24 months ago after years of underperformance from the Toronto Stock Exchange. In my 35 years of talking with Canadian PMs, this is a pretty unusual occurrence. It does, however, represent a trend that I am seeing from all over the world. Indeed, the great rotation has yet to begin in earnest out of fixed income into equities. But, there is a great rotation that is occurring out of non-U.S. equities into U.S. equities. I think that trend is going to continue, and when the rotation out of bonds into stocks arrives, it should be a double whammy for stocks. Last week, however, select correlations broke down with the most noticeable being between the dollar (-2%) and stocks (SPX +0.78%). Interestingly, the cyclical sector performed in line with the stock market, suggesting there was no serious deterioration in the appetite for risk. Also of interest is that since the May 22nd downside reversal, it has been the high dividend payers that have been "sold" with this year's biggest "winners" hanging in there. That is not the way it typically plays. Moreover, last week's softening economic reports imply "tapering" may just be off the table in the near-term, something the equity markets seemed to have figured out last Friday. Meanwhile, there is talk that a seven-month winning streak can't go on, but history shows that seven-month skeins tend to extend for eight months. If so, that would take us into my long-standing "timing point" of mid-July where stocks should become vulnerable to a more meaningful decline.



Source: Thomson Reuters.

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