# Mark's Musings

Whitmore Capital Management Quarterly Newsletter

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## The Difference between Being "wrong," "Wrong" and "WRONG" and What it Means for Successful Investing

### Executive Summary

- Investment mistakes are inevitable. Identifying the type of mistake and understanding its impact is paramount to long-term investing success and wealth building.
- We posit that investors can be wrong in three distinct manners, what we've termed "wrong." "Wrong" and "WRONG."

  - We identify "wrong" as when the vicissitudes of the market move against you for a period of time but you stay the course and your underlying investment thesis remains sound. In such instances, investors are ultimately rewarded for their conviction as prices eventually move in the anticipated direction.

  - "Wrong" is when you recognize a fundamental flaw in your thesis that has led you to incorrectly assess the prospects of an investment or an event. In this case, investors need to alter their thesis to account for the identified flaw.

  - "WRONG" we define as adopting a view of markets that is divorced from valuation. We believe being "WRONG" is a cardinal sin that can threaten the very security of one's portfolio.
- For our part, we were "Wrong" to position the fund defensively in anticipation of an imminent market dislocation once market valuations had reached extremes and failed to climb higher. In the past, once markets had reached such levels and stalled, they had reliably corrected sharply in a matter of months. We did not recognize that market participants' belief in the efficacy of unconventional and extreme monetary policies would allow markets that had reached extreme valuations and stalled to persist in this egregiously elevated state for prolonged periods.
- We have internalized this lesson and over the previous months taken steps to adopt a market-neutral positioning for the fund, waiting for explicit signs of market distress before adopting a hard-defensive positioning.

*"To know that we know what we know, and to know that we do not know what we do not know, that is true knowledge."*

*- Copernicus*

For the better part of two years, I have been rather stridently warning investors both that we appear to be in a third full-fledged financial bubble in less than twenty years, and that their financial well-being may be in significant peril when this bubble bursts. However, over the last seven quarters not only have US markets failed to unwind but, as measured by the S&P 500, stocks have appreciated nearly 5%. During the same seven quarters Whitmore Capital, LP has barely registered gains,[1] creating a rather frustrating period of poor performance for the fund.

Fair questions for investors and potential investors to pose are 1) how could I be so wrong about the direction financial markets have taken in the last couple of years; and (more importantly) 2) how do we know that the poor performance of Whitmore Capital, LP in the last two years will not be indicative of future performance?

I will delve into both of these questions in detail below. But in thinking about how to address the fund's recent failure to achieve meaningful returns, I thought it would be helpful to do so in the context of investing setbacks more broadly. I have for some time conceptualized the types of mistakes investors make in three separate categories: investors can be "wrong," "Wrong" or "WRONG." Understanding the difference between the three, and their distinct ramifications, may be the most important long-term determinant of success for investors.

Before I turn to examining each category, it is important to recognize that our classification and categorization of "wrongness" is necessarily tied to the type of investment strategy we implement and our time horizon for investments. We determine our successes and mistakes in the context of being a long-term, strategic fund. As such, how we classify right or wrong may be starkly different from other investment strategies that may focus on short-term or momentum based factors. Nevertheless, I believe our viewpoints when it comes to identifying the distinct types of errors to which investors can be subject will be informative to any investor seeking to maintain or grow wealth over his/her lifetime.

## I. When Being "wrong" Actually Means Being " RIGHT"

*Everything does not appear together with it's beginning.*

*- Herodotus*

The first category – "wrong" – may appear counterintuitive to some, as I posit this actually leads to net investing profits. It describes instances in which an investor has a very sound thesis as to the expected future movement in price for some asset, acts on that thesis, yet loses money for some period as the price of the asset moves in the opposite direction.

### Market Timing to the Rescue?

I can immediately hear a chorus of protests from individuals saying, "Wait a minute, capital losses are never desirable." Indeed, there are those who argue capital losses largely can be avoided by market timing. Let's say one thinks as I do that financial markets are egregiously overvalued and poised to provide dismal returns over the next decade or so. Market timers would tend to advocate letting your gains run and looking for reliable signals to get out at – or near – the top. The problem with this approach is that there is scant evidence that such reliable indicators exist, or if they do, that they persist.

***"… there is scant evidence that such reliable [market timing] indicators exist, or if they do, that they persist."***

This is where I think the data, analysis and logic of those that adhere to the "efficient markets" theory of investing have it right.[2] Essentially they point out that if market timing was indeed a viable strategy, one would

[1] This is based upon Whitmore Capital, LP net returns through September 2016.

[2] Efficient markets theory is the view that trying to "beat the market" is a futile endeavor, as all relevant information about securities is almost immediately reflected in their prices. Hence whatever the price of a given security, it is the "right price," meaning that trying to speculate that it will go up or down is pointless since the price already properly

see evidence of this by hundreds if not thousands of examples of individuals who beat the market consistently over the course of several market cycles. Having diligently reviewed academic finance literature on the topic, I have found no compelling evidence of market timing strategies providing substantial additional risk-adjusted returns over time. John Bogle, a titan in the financial services industry, famously quipped, "After nearly 50 years in this business, I do not know of anybody who has done it successfully and consistently. I don't even know of anybody who knows anybody who has done it successfully and consistently."

Efficient market theorists also argue that any given market timing strategy logically could not work over time due to arbitrage. Take the "January effect," a market timing strategy premised on the belief that selling before the end of any given year and buying in January would lead to outsized returns based upon one or both of two premises. First, investors having done tax-loss selling before the end of the year would be buying stocks once again in the New Year. Second, Institutional managers would be putting to work new money received from investors. Proponents of this strategy pointed to strong January returns from the mid-eighties through the late nineties as proof of their thesis.

***"… to the extent that market-timing opportunities exist, they are likely to be arbitraged away …"***

However sound these assumptions were, by the time the "January effect" received much attention from investors, it proved to be a strategy that achieved no extra returns compared to an average month, as buyers would bid up stocks in advance of January, thus nullifying its effect. Indeed, once one considers trading and tax costs, investors would have obtained no better than average returns attempting to use this market timing strategy over the last 15+ years. The failure of the "January effect" in recent years demonstrates that the expectation any static market timing strategy could work consistently over time would seem somewhere between extremely unlikely to impossible.

Elaine Garzarelli is a case study in the futility of relying on market timing to catch tops and bottoms. She was probably the most famous woman on Wall Street in the late 80's. The financial press credited her with calling the October 19th, 1987 market crash where the market went down almost 25%. After being hailed for her prescient call, she spent the next twenty years having failed to nail another top or bottom in the markets. Worse still, in October 2007, not two weeks after the S&P 500 hit a theretofore all-time peak, and just before the index began its 50+% slide, Garzarelli declared herself "absolutely bullish" about the US stock market and enthused that "this is a secular bull market." Garzarelli is certainly not alone in having failed to repeat a prior success when it comes to timing inflection points.

In sum, while skeptical, I do not discount the possibility that certain signals unrelated to valuation levels may periodically arise that may lead to investors making short-term trading profits that would exceed what the market would otherwise provide. But there are still two problems that I think make it highly unlikely for retail investors – and indeed the majority of professional investors – to consistently take advantage of any such opportunities. First, they would have to be competing with institutional high-frequency traders using scores and scores of terabytes in computing power to devise sophisticated algorithms to profit from and exploit any market timing opportunities that may arise. The second problem is to the extent that market-timing opportunities exist, they are likely to be arbitraged away as canny traders pile into any such opportunities. So what is an investor to do if it is practically impossible to time consistently one's investments in an opportune manner?

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reflects its value and all relevant information. I should note that while I agree that making accurate short-term market predictions is very problematic given the manner in which information is reflected in market prices, I take exception with their view that longer-term market predictions are futile as well.

**Dollar-Cost Averaging Can Turn Being "wrong" into Profits**

Stephen Roach, a fine economist who perspicaciously warned of the global financial crisis (GFC) well in advance of it commencing, once made an observation to the effect that the job of financial markets is to make as many people look as foolish as possible. Sadly, Roach had a great deal of personal experience upon which to draw. His "financial Armageddon" views had been widely dismissed by most mainstream economists and financial institutions by the time late 2007 rolled around. Since he had been "wrong" for many months, it was even easier to dismiss his dire prognostications as the flawed analysis of someone who did not understand the way in which the Federal Reserve – driven by "The Maestro", Alan Greenspan, and later by Ben Bernanke – was able to guide the economy from the rocky shores of recession or worse.

Of course while Roach was "wrong" as to the timing of the GFC, he was "RIGHT" as to its inevitability. Investors who listened to naysayers like Roach in 2007 and exited markets early were often criticized in the moment. Ultimately, however, these individuals were able to preserve their capital and avoid a tremendous amount of pain as the crisis unfolded. The point is that even if you are early in abandoning risky financial assets due to extreme overvaluations, financial market fragilities or both, only to see asset prices rise yet further, one will still likely be better off in the long run.

Avoiding losses such as those seen during the GFC is one key way in which smart investors with a sound long-term perspective can turn being "wrong" about the timing of something into greater wealth. However, dollar-cost averaging into attractive strategic investments that continue to decline in value is often a way to achieve even greater returns over the longer-run.

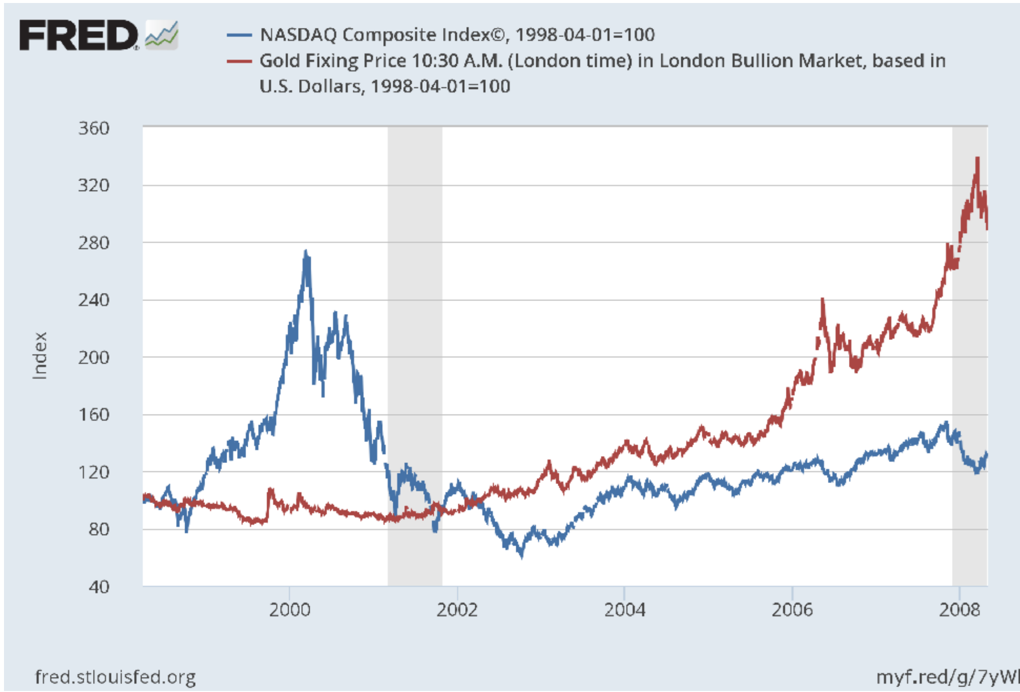
Dr. Marc Faber, investor and publisher of two very fine investment newsletters, the Gloom, Boom and Doom Report and his Monthly Market Commentary, is someone who I have read and followed for more than fifteen years. At least going back as far as April of 1998, Dr. Faber was recommending that investors seriously consider allocating a meaningful portion of their portfolio to gold. Now the context of this recommendation is critical to understand. Gold had just endured an **eighteen-year bear market** in which its price had declined by approximately 65%. Worse still, using inflation-adjusted returns, gold's decline was more like **82%** from its 1980 peak**.** At the time, investors viewed gold as the most moribund of assets, particularly because the tech bubble was driving the stock prices of anything remotely connected to the internet to absurd heights.

The vast majority of financial services professionals scoffed at the prospect that gold was anything but a way to ensure underperformance. Yet Dr. Faber was steadfast in his belief that the long-term opportunity in gold was outstanding. Indeed, it was largely *because* of gold's massive price decline that this was the case. He noted that by the middle of 1998 it had never taken as many ounces of gold (over 30) to buy one unit of the Dow Jones Industrial Index, which was trading above the 9,000 level. This indicated that gold was historically very, very cheap compared to US equities. Conversely, US equities were extremely expensive. Since the most basic goal of investing is to buy low and sell high, it seemed compelling to sell, or at least avoid large exposure to US stocks, while buying gold. Like most sound strategic investors, Dr. Faber did not try to call the bottom of the gold market. Rather he recommended gradual and ongoing accumulation of gold so long as prices remained that depressed.

After Dr. Faber's recommendation, gold not only failed to gain price traction, it declined another 18%, falling from the $310/ounce level in early April 1998 to a low of just over $250/ounce in July 1999. Plenty of figures in mainstream finance took this opportunity to proclaim that Dr. Faber was "wrong." Even many dyed-in-the-wool "gold bugs" (a term for those who are perpetually bullish on the prospects for gold) gave up, selling their gold at large losses and capitulating. Never-

***"… even if you are early in abandoning risky financial assets due to extreme overvaluations, financial market fragilities or both … one will still likely be better off in the long run."***

Exhibit 1. Performance of Gold and the NASDAQ Composite Index (Indexed, April 1, 1998 = 100)




*Source: Federal Reserve Bank of Saint Louis*

***"... dollar-cost averaging into attractive strategic investments that continue to decline in value is often a way to achieve even greater returns over the longer-run."***

theless Dr. Faber and those who believed in the soundness of his analysis not only held their positions but had the opportunity to add to them at even lower prices.[3] Such purchases proved to be very auspicious, as gold prices would skyrocket from their July 1999 lows. It is also worth noting that as predicted by Dr. Faber, myself and many, many others who chose to focus on fundamentals and valuations as opposed to conveniently crafted arguments about how the New Economy rendered traditional valuation metrics obsolete, US stocks precipitously declined (see Exhibit 1, above).

The point of this section about being "wrong" is that too many investors fall into the trap of believing that recent losses necessarily auger future longer-term losses. Rather than seeing opportunity, much like Baron Rothschild exclaimed when he purportedly said "buy when there is blood in the streets," investors can be prone to abandoning what were sound investment decisions simply because market opinion turns against them and they begin to suffer capital losses. At one of my investor forums, I noted that investors should view these type of losses as "good" losses. So long as the investment thesis is sound, temporary losses are an opportunity to buy compelling assets at even lower prices.

It is important, however, that investors do not dollar-cost average into a position simply because the investment in question has become cheaper as this can lead investors toward the far more dangerous outcomes of being "Wrong" or, even worse, "WRONG," both of which will be dis-

[3] For a practical example of how profitable dollar-cost averaging can be, please see the section entitled "Rebalancing for a Better Tomorrow," page six of Whitmore Capital Management's 2Q 2015 Quarterly Newsletter

cussed below. Investors must constantly be doing their homework, subjecting their underlying investment theses to ongoing critical analysis to ensure they still hold true in the current environment. Further, investors should understand and weigh how dollar-cost averaging impacts their overall portfolio and risk management goals. To recall the famous aphorism: The market can remain irrational longer than you can remain solvent. Thus if one is already fully leveraged, adding to an already outsized position can put investors in a more perilous position than they may recognize or intend.

## 11. The Financial Pain of Being "Wrong"

*To make mistakes or be wrong is human. To admit those mistakes shows you have the ability to learn, and are growing wiser.*

*- Donald Hicks*

### Hard Wired to Make Mistakes

So now we move up a level regarding the negative consequences for the investor when I talk about being "Wrong" with a capital "W." Unlike situations where an investor is making decisions based on sound fundamental analysis yet the market moves against him in the short-term, being "Wrong" entails situations where there is a fundamental flaw in the investor's analysis that leads to poor returns for some duration of time. Now the magnitude of the error is directly related to how long it takes the investor to realize how he is "Wrong" and then come up with a remedy. So unlike being "wrong," there are no "good" losses involved. Being "Wrong" is simply something that investors should avoid whenever possible.

The problem, of course, is that, as Donald Hicks points out (and Alexander Pope before him), to be wrong is to be human. The realm of behavioral economics has paid particular heed to the predictable ways in which investors make investing mistakes. As such, it offers valuable insights into the various manners in which investors may succumb to being "Wrong."

Perhaps the most obvious manner in which we are prone to making mistakes is through confirmation bias. This is the phenomenon where we have a particular belief or outlook, and consciously or subconsciously consume information that is supportive of the belief at issue. In so doing we tend to avoid or disregard information and opinions that may challenge our beliefs.

Given that we are (mercifully) at the end of a presidential election cycle, an easy example to highlight is "news" consumption about the candidates. Were an alien who knew nothing about US politics to watch MSNBC and Fox News back-to-back it would probably assume there must be two separate sets of individuals, both of whom happened to be named Donald Trump and Hillary Clinton, running in two separate elections. I find it remarkable that proponents of each candidate have a tendency to be almost rabid in their denunciation of the other candidate, yet view their favored candidate through rose-colored glasses. Part of this lies in the fact that Hillary supporters are not spending much time reading the National Review or the Drudge Report News, while I am sure few Trump supporters are reading Slate or editorials in the New York Times. Again, we tend to want to confirm what our beliefs are, rather than explore with an open mind whether they may be flawed or mistaken.

Another way in which humans tend to be prone to being "Wrong" that behavioral economists have highlighted is our tendency to be consistently overconfident in our abilities compared to when they are objectively measured. The term used for this phenomenon is "illusory superiority." The classic example of illusory superiority is when people are asked about their driving ability, well over half of them indicate that they are "better than average" drivers. We are especially prone to overestimating our abilities when it comes to comparing ourselves to our peers. One classic 1977 study found that *94 percent* of professors thought they were superior to the average professor.

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*"… being willing to consider other points of view and to re-examine one's assumptions, analysis, and conclusions frequently are critical in minimizing the financial damage associated with making what will be inevitable mistakes."*

This tendency may lead investors to believe that they are better stock-pickers than may be the case, or that they can understand complex macroeconomic information better than they truly do. This is why the Copernicus quote that leads this essay is one of my favorites. For I would argue that plenty of relatively smart and successful people have a very good awareness of their areas of specialized knowledge. But I would also posit that it takes someone of exceptional wisdom to know and appreciate the things one does not know. Most of us try, perhaps subconsciously, to fill in the blanks or fake knowing much of what we, in fact, have little to no idea.

One of the reasons I became a money manager is the deeply frustrating experience I had in 2000 and again in 2007 seeing friends be completely complacent that tech stocks and then houses were investments that not only were immune to capital losses, but had much further upside. This was due to a combination of confirmation bias (their friends and the financial media were purporting the same thing); greed (you can only stand to watch your know-nothing neighbor make money hand-over-fist for so long before joining the fray); an inflated sense of understanding of how complex financial markets work; and reliance on the advice of financial services professionals, almost all of whom were urging clients to be bullish at the very peak of both markets.

So when it comes to the issue of being "Wrong" (which again is where one has made a decision based on flawed thinking or situations in which circumstances change in a manner that invalidates one's thesis), I would offer the following thoughts to investors. First, making such mistakes will be inevitable. I am unaware of any great investor (not to mention mediocre or worse investors) who has not succumbed to being "Wrong," and usually not just once. Second, the first step of correcting situations in which one is "Wrong" is awareness. Unfortunately, our tendency to both think we know more than we do and our unwillingness to admit we are "Wrong" can get in the way of such recognition. So being willing to consider other points of view and to re-examine one's assumptions, analysis, and conclusions frequently are critical in minimizing the financial damage associated with making what will be inevitable mistakes. Third, and finally, investors need to be prepared to pivot once they determine they are making a mistake that is causing them either actual losses or just failing to capitalize upon a better strategy.

### My Mea Culpa

While I have previously attempted to explain how an institutional failure with the fund's broker in December 2014 largely explained our disastrous 4th quarter of that year, our relatively flat performance since then is probably a greater mystery to investors and potential investors. While there are many factors that explain performance over the course of many months, the most significant single explanation for our underperformance is that we were "Wrong" in our assessment that financial markets were on the brink of an imminent and precipitous decline. Thus, our decision to position the fund quite defensively proved to cause significant losses which offset virtually all of the gains our core strategy provided.

#### The Two Primary Sources of Anticipated Returns for the Fund

Before delving into the nature of being "Wrong" and its implications for the fund going forward, let me explain a bit about how Whitmore Capital, LP expects to produce returns over time. Our core strategy is to identify currencies that are "mispriced" because they are either fundamentally undervalued or overvalued, going long in the case of the former and going short in the case of the latter. In this way, we attempt to apply sound principles of value investing in the realm of currencies. We believe that over the longer-term, fundamentals determine price movements. On this front, the fund, even in the midst of lackluster performance, has done quite well. In reviewing those currencies about which we had a strong opinion as to their valuation levels two years ago, approximately 80% moved as we anticipated.

A logical question to pose is: If the core strategy is succeeding so well, what accounts for the largely sideways performance since the beginning of 2015 though 3Q 2016? Well, that is explained by the secondary component of how our fund expects to derive returns over time. We use something we call a macroeconomic overlay that modifies our portfolio based upon our expectations concerning how the global economy and financial markets will fare in the future.

A hypothetical example may help illustrate this. Let's imagine that looking through the lens of our proprietary calculus we determine that the South African rand is modestly undervalued and that the South African government at the time looks to be committed to the rule of law and is relatively free-market friendly. In a period in which we anticipated run-of-the-mill economic and financial market activity going forward, such a scenario would warrant taking a relatively modest long position in the rand.

But changing our expectations for global economic and financial performance leads to the rand looking either much more or less attractive. For instance, in a situation similar to the end of the GFC, where the global economy had shrunk significantly, financial assets tanked, and investor sentiment was at its most negative, the rand looks much more attractive. Why? Because stellar investors know that investors *en masse* (the "heard") erroneously make projections about the future based on the recent past. If the sky has fallen, instead of seeing this as a great opportunity to acquire assets inexpensively with an expectation that brighter times will lie ahead, they are inclined to eschew entirely what they now deem to be "risky" assets. And make no mistake, the rand is a classic "risk-on" asset. When investor appetite is prone towards complacency and speculation as opposed to fear and risk-aversion, investors are more inclined to own the rand and assets denominated in the rand.

So, in the environment described above, which is similar to what we saw in late 2008 and early 2009, global investors would have already panic-sold the rand and almost all other "risk-on" assets. This coupled with the increasing likelihood that the global economy was at or near a floor, would cause us to increase our investment in the rand using our macroeconomic overlay. This is because we would expect investors will eventually return to deeply discounted "risk-on" assets and as the economy improves cyclically, the rand will perform even better than our expectations based solely on its fundamentals at the time.

### The Problem of Anticipated Inflection Points

I should highlight something that is very important to keep in mind regarding fund returns. It should come as no surprise that the possibility of poor short-term returns is the *greatest prior to* anticipated inflection points for financial markets. Using the hypothetical example above, it may be that after going long the rand that financial markets and the global economy do not imminently turn a corner. The rand may become even cheaper, and we would be, for a time, "wrong" about its turnaround. But as described above, these would generally be seen as "good" losses, creating an opportunity to dollar-cost average into an already attractive asset at even better prices.

Importantly, empirical results demonstrate that the future returns of "risk-on" assets are almost certain to be abysmal when financial assets are extremely overvalued, and superior when valuations have collapsed. In early 2000 the S&P 500 had hit nosebleed valuations; It was at new all-time highs and was sporting a price-to-earnings ratio of 30. While it revisited those highs a few months later in August 2000, the market then proceeded to tank by almost 50% over the next two years (see Exhibit 2, below).

Something very similar occurred in 2007, with markets revisiting their turn-of-the-millennium highs around May, then revisiting those highs in October before spending the next 18 months declining more than 50%

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*"There is sound theory behind the expectation that once extreme valuations in either direction have been reached and markets stall, an inflection point is likely to appear within several months."*

Exhibit 2. S&P 500 Performance 1999—2002


*Source: StockCharts.com*

Exhibit 3. S&P 500 Performance 2007-2009


*Source: StockCharts.com*

from their peak. Conversely, once stocks had collapsed in the 40% range, within months markets found a floor and began appreciating significantly from there (see Exhibit 3 on the previous page).

There is sound theory behind the expectation that once extreme valuations in either direction have been reached and markets stall, an inflection point is likely to appear within several months. It has to do with the interplay between traders and investors in financial markets. As most people are familiar, traders are interested in price action and directionality. During bull markets, like 1982-2000, 2002-2007 and 2009 through the present, they are inclined to assume the continuation of an upward trend. However, when markets become dislocated, they generally have little-to-no conviction and are quick to exit the market. Now if traders were the only actors, markets would be far more volatile as they would be constantly and frenetically driving the markets up and down. But as long as valuations remain attractive, the second category of actors in financial markets – investors with an eye to value – assert their influence and buy the dips. This stabilizes markets and prevents stocks from completely unraveling *most of the time.*

When markets are poised to have their most explosive turnarounds (not the day-to-day, or even month-to-month "noise" that is common) are when traders and investors act in a manner *reinforcing* market movement in the same direction instead of counteracting one another. For instance, when valuations are stretched to absurd levels such that investors looking for value do not find even a 10% dip attractive, all it takes is a period when traders are spooked (or maybe just looking to lock in some gains), and markets can fall precipitously. Similarly, during a bear market there comes the point when even if traders continue to chase price direction lower, value-based investors will counteract this by buying undervalued assets. When this happens, price direction moves upwards, and traders then begin to reinforce what value investors are doing by going long as well.

The takeaway from all of this talk of inflection points is that when markets are stalled at extreme valuation levels for several months, they are highly unstable, with both sound theory and market history showing that it is reasonable to expect them to turn in the opposite direction in short order. Or at least that is what **had been** reasonable to believe.

## Market Participants' Belief in the Efficacy of Unconventional and Extraordinary Monetary Policies Has Proven Me "Wrong"

*The problem with speculative bubbles is that until the consequences arrive, idiocy can masquerade as genius and vice-versa.*

*- John Hussman*

As fund investors and regular readers of these reports are probably well aware, I have been warning people that financial markets appear poised on the precipice of yet a third financial bubble in little more than fifteen years. Beginning in the last half of 2014, valuation extremes in US stocks began to surpass those immediately preceding the global financial crisis. Based on the analysis above, I thought it prudent to position the fund to take advantage of the expected decline in asset markets by maintaining defensive currency positions for most of the last two years as part of our macroeconomic overlay.

Unfortunately, it is expensive to take defensive positions in currency markets. This is because one is generally long "safe" low-yielding currencies and short "risky" high-yielding currencies, oftentimes in emerging markets. What this means is the fund essentially pays what can be onerous net interest charges to hold these positions. Now in the event of reasonably imminent market declines, such as those seen following the April 2000 and May 2007 market peaks, one can expect to more than make up for those interest rate charges through seeing "safe" currencies appreciate at the expense of the "risky" currencies as markets dislocate.

***"… something has changed, making it possible for markets to remain elevated at very high valuation levels, neither climbing rapidly or collapsing, for much more prolonged periods of time … Enter stage left central bankers and unconventional monetary policies."***

*"… investors appear to have drunk the Kool-Aid, having faith that central bankers will pull all the right levers ... to prevent yet another financial bubble from bursting. While I am confident this will not be the case, that is largely beside the point. So long as investors remain complacent and continue to invest in speculative assets … the game of musical chairs continues."*

However, more than two years after markets climbed into egregiously overvalued territory in 2014, far from breaking down, US markets (as measured by the S&P 500) are up more than 5%. Thus, not only has our defensive macroeconomic overlay caused significant losses from being short high-yielding currencies for which we have had high interest rate charges, but many of those currencies (the Brazilian real in particular) have appreciated recently, causing some significant capital losses as well. The magnitude and duration of these losses have meant we were "Wrong" with a capital "W."

It strikes me that the reason for being "Wrong" is almost as important as recognizing the fact that we were "Wrong." There are two possibilities. First, our assessment that financial markets are absurdly overvalued and that the global economy is fraught with fragilities is simply incorrect, and investors are not in store for very disappointing returns in traditional assets after all. For reasons highlighted below, I think the odds that this is true are between slim and non-existent.

A second possibility is that something has changed, making it possible for markets to remain elevated at very high valuation levels, neither climbing rapidly or collapsing, for much more prolonged periods of time than has ever been true. Importantly this does not mean that markets will *avoid* significant declines in the future (indeed, I would argue that is all but pre-determined), just that declines have been able to be forestalled.

Enter stage left central bankers and unconventional monetary policies. Now I have been a merciless critic of Janet Yellen (and Bernanke before her, and Greenspan before him). In short, I think we are poised to succumb to the third financial bubble in less than two decades because, instead of letting the internet bubble burst and endure the necessary restructuring and dislocation in the US economy, Greenspan attempted to avoid the bulk of the economic consequences by artificially depressing interest rates. This in turn helped spawn the housing/credit bubble in 2007. When this bubble burst, Bernanke then did everything in his power to avoid its consequences by pursuing not just near-zero interest rates, but quantitative easing as well.

To be clear, money printing *ad infinitum* does **not** lead to prosperity. If that were the case, every central bank would just credit everyone's bank account with $1 million, and we could all be rich. But all the details as to why unconventional monetary policies are doomed to fail is beyond the scope of this essay.

What is important is that investors appear to have drunk the Kool-Aid, having faith that central bankers will pull all the right levers within the global economy to prevent yet another financial bubble from bursting. While I am confident this will not be the case, that is largely beside the point. So long as investors remain complacent and continue to invest in speculative assets, the music continues to play, and the game of musical chairs continues. Whereas it was formerly profitable to be pre-emptively defensive when valuations reached absurd levels and stocks began to plateau, we now see for the first time in financial history that investors are willing to endure sideways performance in elevated markets without panicking and running for the exits.

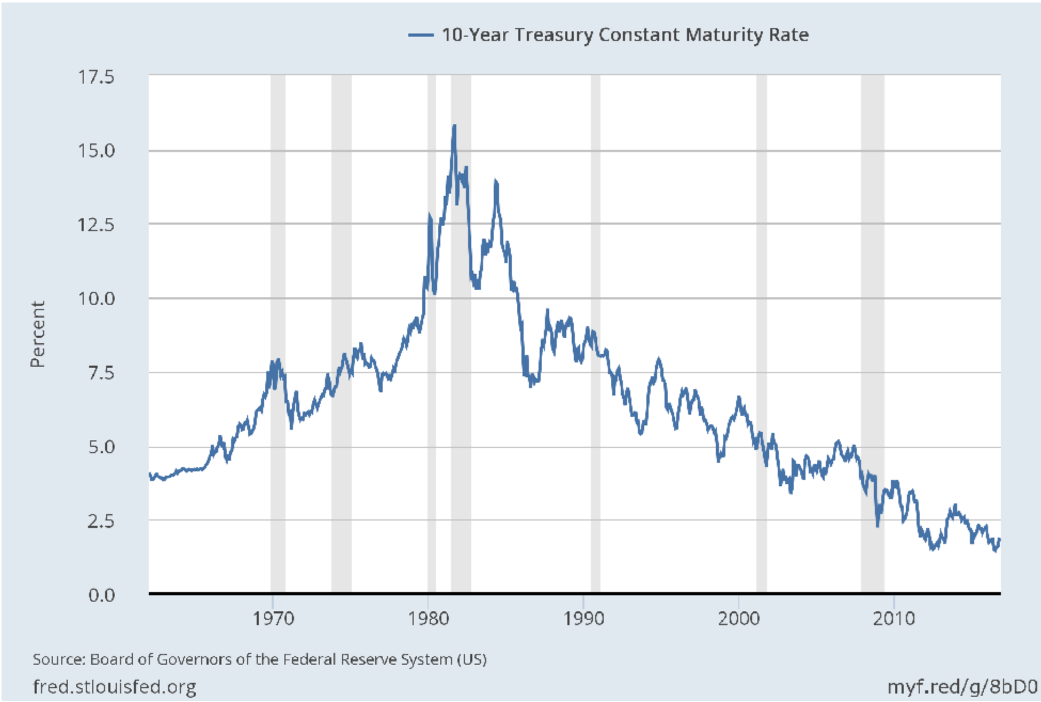
*This* is what has changed and is how I was "Wrong" about how long financial markets can defy gravity. I significantly underestimated the credulity of investors.

### The Upside of Being 'Wrong"

Now unlike being "wrong," where there is the prospect of enduring temporary short-term capital losses to obtain longer-term capital gains as discussed above, there is no such upside with being "Wrong." However, so long as one is not stubbornly set in one's ways, there is always the ability to recognize one's mistaken analysis or assumptions and take corrective measures.

One example of this is how the majority of US bond investors and financial pundits

Exhibit 4. US 10-Year Treasury Yields




*Source: Federal Reserve Bank of Saint Louis*

failed to see the best opportunity for profits ever for the asset class back in the early 1980's. Bonds had been a toxic investment for over fifteen years. Inflation, first from the guns and butter policies of the Johnson administration and then from the oil shocks of the 70's, had caused interest rates on ten-year US bonds to rise from the mid 3% range to over 13%. As bond prices are inversely related to interest rates, this caused devastating capital losses for what was supposed to have been a "safe" investment.

Yet in August of 1979 Paul Volker was appointed Chairman of the Federal Reserve. In both words and actions, he was determined to break the back of inflation in the US economy. Despite the US being mired in a period of stagnant economic growth, Volker began to raise interest rates aggressively. This is something I dare say no current central banker among any of the major developed economies would have the courage to do. Investors initially did not recognize the tremendous opportunity in the bond market provided by a central banker determined to crush inflation expectations even if it meant precipitating a recession. Ten-year bond prices fell substantially from early 1980 through the third quarter of 1981 even though inflation rates had peaked in early 1980. It was only after ten-year bond yields peaked at almost 16% towards the end of 1981 that bond prices would begin their thirty-five-year bull market (the end of which I believe we are almost certainly now witnessing). But even though most bond investors failed to capitalize on the initial profits to be made in bonds, there was plenty of time for them to recognize that they were "Wrong," amend their analysis, and earn excellent returns for a very long time (see Exhibit 4, above).

In my case, I certainly wish I would have realized sooner that unlike past instances of markets being stretched to historically egregious valuation levels and then stalling, an

***"… so long as one is not stubbornly set in one's ways, there is always the ability to recognize one's mistaken analysis or assumptions and take corrective measures."***

*"... the excellent performance generated by our model in identifying mispriced currencies has been undermined by our macroeconomic overlay, because of which we had largely positioned the fund for market declines that have yet to materialize … [recently] we have modified this overlay to be more market neutral absent clear indications that financial markets are … poised to unwind ..."*

imminent fall was not in the cards because investors **perceived** central banks, armed with vast and unconventional policy tools at their disposal, will somehow prevent the inevitable. Fortunately, since the early part of the summer we have taken measures that I think have already had a positive effect on returns, and I expect will continue to do so going forward.

First, we have reduced leverage for the fund and will continue to maintain reduced leverage until we are no longer waiting for inflection points in the market. Whereas in the past waiting for inflection points once markets had stalled at extreme valuations was a matter of several months, we have now seen it can be a period of time much longer. Since we know our worst expected returns are times in which we think financial markets are headed one way in the medium-to-longer-term, but are either moving in the opposite direction or going sideways in the short-term, reducing our leverage is prudent.

Second, and most importantly, even if we are convinced that markets are inevitably poised to reverse course significantly, we will remain largely market neutral regarding positioning our portfolio unless and until we see signs that **actual market conditions** are reversing themselves. Again, the rationale for this is that if markets can remain at absurd valuation levels for much longer periods of time than ever before, we want to minimize the amount of time we spend swimming upstream awaiting financial gravity to assert itself once again.

Now the downside of this is similar to the bond example mentioned above. Namely, the fund might miss out on the initial returns should markets move in the direction we expect while we have a largely market-neutral positioning. However, because we will be waiting for signs of any such reversal, the fund should be well-positioned to pivot rather quickly to take advantage of the vast majority of gains to be had. Furthermore, if that will prevent the fund from enduring interim losses, based upon interest charges or of the capital nature, so much the better.

It is worth emphasizing that our market-neutral positioning does not mean that we are neutral as to the ultimate prospects of markets, especially US equities and global debt markets. We have not discarded our conviction that valuations remain extremely stretched and that markets are acutely vulnerable to significant losses given the yawning gap between economic fundamentals and security valuations. It just means that we have attempted to position the fund so as to be agnostic to the movements of markets unless and until we see evidence that markets are dislocating.

Third, should we move to a hard defensive posture because we see evidence financial markets are rolling over, yet after a while markets stabilize or improve, we will be quick to revert to a market-neutral positioning. One of the things that has hurt fund performance in the last year were the months *following* sharp market declines such as those of August and September of 2015, and again in January and February of 2016. These were instances when markets rebounded sharply, yet the fund was still very defensive in its portfolio positioning. This is borne out by the fact that the fund's two worst months over the last year were October 2015 and March 2016.

In short, the excellent performance generated by our model in identifying mispriced currencies has been undermined by our macroeconomic overlay, because of which we had largely positioned the fund for market declines that have yet to materialize.

In sum, since the beginning of the Summer, we have modified this overlay to be more market neutral absent clear indications that financial markets are either poised to unwind or are in the process of actually doing so. Should such indications arise, we are prepared to pivot to a defensive positioning; however, we will be quick to revert to a market-neutral positioning should there be no downside follow through. We have also reduced leverage to reflect the fact that waiting for an inflection point in the markets presents the period of greatest challenges when it comes to fund returns. So far, while not having a lot of data points to assess, we have been pleased with the results and expect better fund performance than we saw between the beginning of 2015 to the middle of 2016, *even if* markets fail to dislocate in the manner we expect.

## III. Investors Must Avoid Being "WRONG" at all Costs

*Insanity is Repeating the Same Mistake and Expecting Different Results.*

*- Hazelton Foundation Pamphlet, 1980*[4]

I have tried to explain how being "wrong" is a good thing, and how being "Wrong," while never a good thing, can at least be taken as a lesson for investors to be learned from and thus remedied. We now find ourselves, to invoke Dante for emphasis, discussing the inner circle of wrongness, one which could even be fatal to the long-term success of investors today. I define being "WRONG" as adopting a view of markets that is divorced from valuation. Let me give you the three most prominent examples where investors are "WRONG" of which I am aware and admonish everyone to do everything in one's power to avoid these mistakes.

The first mistake investors commonly make leading to being "WRONG" is holding, or worse continuing to acquire, extremely expensive assets in one's portfolio, particularly if this is done in a concentrated manner. I knew scores and scores of people who plunged huge percentages of their net worths into housing a decade ago, and about the same number of people seven or eight years before that who had invested large sums in technology stocks. Both of these assets shared a great deal in common. They had both performed spectacularly well as investments in the preceding several years. Both technology stocks in 1999 and US houses in 2007 were trading at price levels that were unprecedented. And both had apologists who proclaimed that these assets were impervious to the kind of declines that those of us who were focusing on valuations were sure would occur. As regular readers of my quarterly reports know, I believe US stocks and global bonds are extremely expensive, and thus look to be poised to underperform significantly in the coming years. My grave concern is that investors who continue to acquire or hold these assets without an awareness of their extreme valuations will be proven "WRONG" when the prices of these assets decline to levels consistent with their fair valuation.

The second common mistake leading to being "WRONG" is simply the reverse of the one just mentioned. Once in a rare while, there are market collapses that lead to tremendous buying opportunities. The first quarter of 2009 saw US stocks down more than 50% from their 2007 highs. Despite this, there was no torrent of buyers flooding the markets picking up bargains in almost any "risk-on" asset. Rather, investors eschewed and even *continued to sell* anything with a hint of risk, incorrectly projecting the massive declines of the recent past into the future.

As I have pointed out before, when you add these two mistakes together, as many retail investors are prone to do, you get an investment strategy composed of, "buy high, sell low." Obviously, this is a sure fire way of obtaining abysmal investment returns.

The third way in which many investors are at risk of being "WRONG" is by far the most controversial, as there are not many that would argue for a "buy high, sell low" investment strategy. While less pernicious than the previous examples, a "buy and hold" investment strategy that fails to consider the valuations of the assets held will occasionally, but quite predictably, lead to devastating losses.

Now I should note that between the mid-eighties and the late nineties I tenaciously

***"I define being 'WRONG' as adopting a view of markets that is divorced from valuation."***

[4] Oftentimes incorrectly attributed to Albert Einstein, Ben Franklin or Mark Twain.

maintained that buy and hold investing was the superior approach. But by 1998 I lost faith in the strategy. This was because I could find no rational basis justifying the price of scores and scores of speculative internet stocks. Furthermore, when I looked at valuations of the market as a whole, I found that it had not been at such stratospheric heights since 1929. In the end, the only way in which I could make sense of technology stock prices was to develop an analytical framework very similar to that being used by the early proponents of the fledgling school of economic thought known as behavioral economics. Namely, that asset prices are not just determined by their rational prospects of returning shareholder value over long periods of time. But rather are often, and quite predictably, largely determined by human nature, and specifically our tendency to vacillate between greed and fear. And indeed the first two examples of being "WRONG" detailed above highlight the investing folly associated with acting out of greed (buying after seeing one's friends and colleagues getting rich and when prices are high) and fear (having held an asset through grinding losses and finally selling in capitulation at very low prices).

***"While less pernicious than the previous [buy high, sell low] examples, a "buy and hold" investment strategy that fails to consider the valuations of the assets held will occasionally, but quite predictably, lead to devastating losses."***

I should note that empirical research plainly demonstrates that when it comes to buying equities, longer-term returns (10-12 years) are **almost entirely determined by valuation**. John Hussman of Hussman Funds continues to produce the best data and analysis of which I am aware on this topic. He has tracked S&P 500 returns going back 90 years and compared this to the valuation measure of nonfinancial market capitalization to nominal GDP. What he has found is that there is a -91% correlation between the market's valuation level (using this measure) and the subsequent 12-year return of the S&P 500 (the correlation is negative as higher valuations imply lower subsequent returns). Put simply, twelve-year returns are *uniformly* outstanding when stocks are quite inexpensive, and *always* poor when they are very richly valued.

The bad news for investors is that we are presently at an overvaluation extreme seen only in approximately six other years out of the last ninety! In the prior instances between 1926 and 2006 in which US equities were this richly valued, the *best nominal* ten-year annualized total returns were approximately a mere 4%, while the worst were an appalling *negative* 2.5%! Conversely, when looking at the six years in which valuations were at their cheapest, the worst ten-year annualized nominal returns were approximately 15% (for a total ten-year return of 300%), while the best were roughly 19% (with total ten year returns of roughly 470%!).

It is thus evident that taking the view that longer-term returns are somehow unknowable simply does not comport with hard data. But this is the basis for buy and hold investing – since the market perfectly reflects all the known information about the economy and the prospects for all publicly traded companies, it is futile to predict the future direction of markets, and one should simply hold these equities through thick and thin. This mentality has caused not just one, but two instances of mass vaporization of paper wealth, totaling in the tens of **trillions** of dollars in less than a decade. It is also the mentality that drives the portfolio composition touted by the vast majority of wealth managers and financial advisors.

I want to be very clear about this. I think that investors counting on total returns over the next 10-12 years for US stocks, bonds or some combination thereof which exceed 4-5% annualized *nominally* are almost guaranteed to be disappointed. I expect a portfolio of 100% US stocks is only about 60-80% likely to keep up with inflation, and if it does, it will most probably not be by very much. As for a portfolio of 100% "safe" bonds, it is almost guaranteed that investors will not even be able to do that.

Being wrong as an investor is inevitable. But as I hope is clear by now, the manner in which one is wrong makes all the difference in the world. Hopefully one is "wrong," in which case one can expect to be rewarded with longer-term gains that will more than eclipse whatever ephemeral losses one might incur while seeing one's cheap assets get cheaper for a time.

If not, realizing that one is "Wrong," hopefully as early as possible, is still not dire. I can think of nothing in the world, truly, that is more complex than the interplay of financial markets. This is particularly the case once one factors in the fact that the actors in the financial marketplace frequently do not act rationally or predictably. Investors cannot avoid mistakes. But one can take solace in realizing that assuming one's gains and losses are in line with one another on various investments, it is possible to be incorrect about 40% of the time and still have impressive investment returns.

I have recently realized how we have been "Wrong" to have positioned the fund defensively over much of the last seven quarters based upon an expectation of an imminent unwinding of financial markets. Fortunately, I think we have taken several concrete actions to better position the fund to avoid the kind of sideways returns we have endured since the beginning of 2015.

However, being "WRONG" as an investor can threaten the very security of one's portfolio. The "buy high, sell low" mentality seems to be engrained in most investors' psyche. But investors can escape this tendency by disciplining themselves, particularly by being very aware of valuation measures to better ensure they are buying low and selling high. In some ways, while likely doing less harm to one's portfolio, falling into the buy and hold mindset trap is more problematic than tending to buy high and sell low. By its very nature, the strategy resolutely rejects the possibility that one should ever deviate from continuing to acquire securities, regardless of valuations. As such, there tends to be an intellectual inflexibility to consider the evidence that buy and hold investing is a sure-fire way to lose money when markets are stretched to their highest valuation extremes. Because I believe we are currently in such an environment, I suspect we will see yet a third instance of financial markets imploding, with an army of wealth managers and financial advisors making a litany of excuses as to why they did not see it coming. *Caveat Emptor*!

***"Being wrong as an investor is inevitable … the manner in which one is wrong makes all the difference in the world."***

**- MW**

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**[*] Past results are not necessarily indicative of future results. You should carefully consider whether your financial condition permits you to participate in a commodity pool. In so doing, you should be aware that commodity interest trading can quickly lead to large losses as well as gains. Such trading losses can sharply reduce the net asset value of the pool and consequently the value of your interest in the pool. References to specific securities and issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities.**

WHITMORE CAPITAL MANAGEMENT

## *About Whitmore Capital Management, LLC*

Whitmore Capital Management, LLC was formed in 2012 to offer investors access to a proprietary foreign exchange investing program (the Fund, Whitmore Capital LP). This program focuses on cash currencies but may also include futures, forwards and currency options. The objective of the Fund is to achieve long-term returns superior to the Credit Suisse Hedge Fund Index.

At the very core of the investing program is a mathematical model developed by Mark Whitmore. This proprietary calculus for determining the "fair value" of exchange rates aims to identify long-term opportunities to profit from temporary currency market mispricing. The outcome of these quantitative analyses are supplemented by qualitative analyses of the circumstances surrounding each currency to determine the configuration of the portfolio itself. Finally, sentiment indicators are reviewed as an additional analytical overlay. Currencies traded for the Partnership's account may include, but are not limited to, pairs of the following currencies: AUD, BRL, CAD, CHF, CNH, CZK, DKK, EUR, GBP, HKD, HUF, ILS, JPY, MXN, NOK, NZD, PLN, RUB, SEK, SGD, TRY, USD, ZAR.

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