

Org and Torg Go Hunting

“There is a bear in the woods. For some people the bear is easy to see. Others don't see it at all. Some people say the bear is tame. Others say it's vicious and dangerous. Since no one can really be sure who is right, isn't it smart to be as strong as the bear? If there is a bear....” -- *Ronald Reagan campaign advertisement, 1984*

You can find wisdom in the oddest places, perhaps none odder than a political advertisement. The bear in the ad was a metaphor for the Soviet Union, but it also works with the bear symbolizing a falling stock market. Financial market pundits, most of whom work for organizations with a vested interest in selling investment products, are loathe to recognize the possibility, if not the certainty, of the bear in the woods. A cursory glance at market history tells us that there is *always* a bear, eventually. So why do people persist in thinking that the bear is not there, or that if it is, it is tame? We tend to extrapolate the recent past. This does not work for the stock market, though, since what we extrapolate is just a derivative of reality. Stock prices reflect, imperfectly, the reality of the condition and prospects of the underlying companies. While reality changes only slowly, our opinion of the reality can change quickly and wildly. If reality is a straight horizontal line, our perception of reality is like a sine wave fluctuating around the line. At the peak of the wave, anyone extrapolating the recent past believes the line will continue ascending forever, rather than changing over into the downward cycle.

Between the summer of 1982, almost 26 years ago, and last October, the Dow Jones Industrial Average rose from under 800 to about 14,000. Everyone expressing an opinion on the stock market today is doing so in a context in which the market has gone almost straight up, with just a few detours, for more than a quarter of a century. Even if you are one of the experienced few who were investing before 1982, your recent investment experience has been the largest bull market in U.S. history. During that quarter century, buying the dips has been a winning strategy; selling anything, anytime, has been a mistake, on average.

Consider, however, how the world looked during that summer of 1982. The Dow Jones Industrial Average, on an inflation-adjusted basis, sold at a price almost two-thirds lower than its price in the summer of 1929. For more than a *half century*, the real trend of prices was down. Sure, you had the huge bull market through the 1950s and 1960s, one of the largest bull markets in history, but it had all been for nothing if you held on during the stagflation-induced bear markets of the 1970s. Other than the dividends you received from holding stocks during this period, selling the rallies was the winning strategy for 53 years, on average.

In the late stages of a bull market, investors worry about opportunity cost (missing potential profits), roughly equating it to a real loss of capital. In a bear market, they come to realize that real losses are much, much worse.

Imagine we had a time machine and could go far back in time to consider the cavemen Org and Torg. These are not the urban sophisticates of the Geico advertisements, but honest-to-goodness cave dwellers hunting with spears and clubs. All the other animals in Org and Torg's world have some physical advantage (speed, armor, teeth or claws), while our heroes have only their brains to help them. While they are hunting, a nearby bush rustles. Is it a bear or just the wind? If it is a bear, they want to run away as

fast as they can (disregarding the suggestion of the Reagan ad, they are disinclined to actually fight a bear). If it is just the wind, there is no need to run. Org and Torg, however, are smart enough to realize the asymmetry of their decision. Even if it is the wind nine times out of ten, the bear only has to be there once to kill them. The real loss of their life weighs heavier in their primitive minds than the more frequent opportunity cost of being tired from running away.

Occasionally, throughout history, everything changes. Inflation comes out of nowhere; strange derivatives create problems, etc. Imagine Org and Torg suddenly are no longer in a forest but on a savanna, it is a clump of grass that is rustling and what might jump out if they are unlucky is a saber-toothed tiger. The asymmetry principle is the same, however, as all the Orgs and Torgs quickly realize - at least all the Orgs and Torgs that survive. Now assume that for 100 or 1,000 straight times, the grass rustling is just the wind. Our heroes will relax a little, be less quick off the mark in their escape and, consequently, be a little easier prey for the tiger that will eventually be lurking behind the grass. If you assume there is still danger in the world, complacency induced by long periods of safety increase the magnitude and likelihood of eventual disaster. In an evolutionary sense, if you assume that danger is cyclical (e.g., that tigers, bears and stock market declines are not extinct), the illusion of safety increases the chance of catastrophe.

At Sigma, like Org and Torg, we realize the asymmetry of loss. As you approach retirement, the danger of capital losses or loss of purchasing power becomes more acute, because you lack the time and the earning power to recover. Still, many investors appear to have trouble seeing this asymmetry. Call us at (503) 419-4038 or contact us through www.sigmainvestment.com if you would like to be smart and prepare for the bear. If there is a bear....