HAWK 100

HAWK Talon

Monthly News from Hawk100 — Issue 17, May 2010

Bearish Causality Paradox?

The S&P 500 dropped 7.99% in May on increased concerns that the problems evident in Greece will spread to other investor markets. The monthly decline was the first for this index since January. Still, The Wall Street Journal reports this was the largest loss in May since 1940.

The international stock index, MSCI EAFE, declined 11.51% in May alone and 12.36% for 2010 cumulatively. This index holds approximately 65% of its assets in issuers from European countries.

In a flight to relative safety, investors flocked to long U.S. Treasuries. Barclays 20+ Year Treasury Index rose 5.2% in May. That was the index's highest one-month return since December 2008. 10-year treasuries now yield 3.26%.

Short-term borrowing rates remain about as low as ever. U.S. prime rate is 3.25%; the Fed funds target is 0—25 basis points; 3-month LIBOR is 0.53%; and 90-day commercial paper yields is 0.48%

Cheap borrowing and opportunity costs normally boost stocks, but low rates have persisted for a decade. That bull may have run, chased off the stock chart mountain by an approaching bear. Was the polar bears' coincident arrival in Columbus an improbable causality paradox for a coming bear market?

Your wealth.
Your life.
Aligned.

6600 Perimeter Dr.
Suite 200
Dublin, Ohio 43016

614.791.HAWK

www.hawk100.com

Herd Mentality.

We wonder whether she remembers lessons from her last trade.

To well deserved fanfare, the Columbus Zoo recently opened its long awaited polar bear exhibit, and I have animals on my mind.

I enjoy the music of Pink Floyd. Their 1977 album *Animals* opens, "If you didn't care what happened to me, and I didn't care for you, we would zig zag our way through the boredom and pain . . . wondering which of the buggers to blame." The lyrics evoke images of certain stock brokers. I visualize brokers whose emotionless disregard for their counterparty results in interactions that cause stock values to zig and zag, often boringly yet at times painfully. When painful, the losers peg blame on some scornful bugger.

The SEC and Congressional case unfolding against Goldman Sachs resembles a public lynching of a bugger, absent due process, for political expedience. The case's subject deal is a derivative contract, a collateralized debt obligation (CDO), based on the value of collateralized mortgage obligations which are themselves securitized packages of mortgages. Derivatives are zero-sum games—profits exactly offset losses—so it was guaranteed one side of Goldman's CDO would lose, but no one knows which side would eventually win or lose. Sophisticated investors who bought the CDO would have expected a zero-sum outcome. I am no Goldman fan, but the case against them appears hollow.

On *Animals,* Pink Floyd continues, "you've got to be crazy, … got to sleep on your toes, when you're on the street . . . You've got to strike when the moment is right without thinking." Those lyrics elicit further images of traders placing irrational bets during market extremes. With alarming frequency, otherwise thoughtful investors take rash action as if mindlessly following a herd in the heat of the moment. Malcom Gladwell calls this decision making process, thin slicing, and behavioral finance research explores these humanistic, or perhaps animalistic, errors of investor behavior.

This month, I spoke with Jason Zweig, *The Wall Street Journal*'s "Intelligent Investor" columnist and author of *Your Money and Your Brain*; and Richard Peterson, author of *Inside the Investors Brain: The Power of Mind Over Money*. Their research has helped explain how the human brain behaves under financial stimuli leading many toward irrational decisions. When asked why he chose to focus his research on behavioral finance, Zweig responds that it was the only question not adequately answered among the various professional journals. Zweig calls his science "neuroeconomics" precisely because it focuses on neural responses and processes with respect to economics. In its core areas, the human brain acts quite like that of an animal, yet those areas can drive investor decisions. When Zweig excuses himself from our conversation, he provides a reason that reinforces the animalistic nature of our brains. He must help his daughter's school research project—the subject, gerbils' brains.

We continue the animal theme with the May 20 science journal publication that geneticists led by Craig Venter successfully created a living, reproductive organism. The single-cell *Mycoplasma mycoides JCVI-syn1.0* was created by transplanting purely synthetic DNA into a recipient cell which then was controlled completely by its new DNA. The J. Craig Venter Institute research opens debate concerning creation theories, ethics, and regulation. Their transformative research illustrates the power of the human brain to open a world of possibilities—opportunities and threats—for economics and life. Hawk100 will watch this developing science for investment opportunities and threats.

Animals ends with an uplifting thought. "You know that I care what happens to you, and I know that you care for me, so I don't feel alone." So we close with this allusion to the benefits of Hawk100 membership. Members belong with an organization that uses prudent processes to align their wealth while always placing member interests first.

By Richard Clemens, CFA, President