The QAM letter that highlights recent developments that we think either affect the markets or are important to understanding them.

"The reason for overconfidence may also have to do with hindsight bias, a tendency to think that one would have known actual events were coming before they happened, had one been present then or had reason to pay attention. Hindsight bias encourages a view of the world as more predictable than it really is." - Robert Shiller, 2000

Kids Say the Darndest Things

For many months our written updates have examined the theme of attractive equity valuations versus inherent risks in owning fixed income instruments. The fact that world equity markets have provided double digit returns over the past two quarters has not changed our position on the intrinsic opportunities in equities and intrinsic risks in fixed income investments.

A standing agenda item in our regular Investment Committee meetings is the theme of the current month's QAM Update. The genesis of this update comes out of the mouths of babes. When framing her behavioral choices to her parents, the six year old daughter of one of our team explained, "Daddy, we all have a smart side and a silly side". Most behavioral economists and psychologists would tell you that she is right.

In a more analytical sense, we can say that we all have a rational side (what the little girl would call smart) and an emotional side (silly). Behavioral neuroscientists have long come to the conclusion that, at the individual level, the emotional side driven by sentiment dominates for the most part over the rational side, particularly in periods of stress.

In his NY Times bestselling book, "Thinking, Fast and Slow", Nobel Prize winner Daniel Kahneman outlines a framework for the tug of war between our rational and emotional side. System 1 (Thinking Fast) is unconscious, intuitive and effort-free; System 2 (Thinking Slow) is conscious, uses deductive reasoning and takes energy. We all like to think that System 2 (rational) dominates our decision making. In reality, research shows that System 1, more often than not, runs the show. This is not a flaw, rather it reflects the reality that there is simply too much going on in our lives to have the time and energy to allow System 2 to dominate. With the exponential increase in decisions that we face, and the corresponding availability of information (often conflicting), it is safe to say that System 2 can be expected to continue to defer to System 1.

If we, as human beings, are environmentally and naturally inclined to more emotional decision making, then the movements of the capital markets must be subject to the influence of the combination of those individual decisions. Despite what rational and thoughtful examination tells us should occur, often markets are driven by sentiment. It is the impact of this sentiment that generates volatility and, in extreme cases, what are sometimes referred to as Black Swan events. Making such so called "statistical anomalies" more normal than we (and in particular statisticians) would like to believe (or experience).

This proven reality of "System 2" decisions can limit the usefulness of quantitative models, particularly in the short term. In his book "Models.Behaving.Badly: Why Confusing Illusion with Reality Can Lead to Disaster, on Wall Street and in Life" Emanuel Derman (former head of quantitative analysis at Goldman Sachs) says that "the behavior of people changes and normal models fail."

We believe that our clients pay us to think. Morever, our job as professionals is to objectively understand the risk of making decisions driven by our own emotions, and structure our decision making based upon deliberate and rational attention to the facts and our clients' objectives.

As we have suggested over the past months, our clients should continue to focus on a balanced portfolio that reflects their risk tolerances and provides for liquidity needs while capturing positive inflation-adjusted returns from a well constructed portfolio of stocks. We continue to see attractive equity valuations, particularly relative to fixed income instruments. Review and rebalance of asset mixes versus long term targets will be critical as valuations in equities expand and perhaps become overvalued in the face of an environment of overly positive sentiment. This deliberate process will help us avoid a System 1 answer to another gem that we often hear from children, "Are we there yet?".