

# The Human Perception of Risk, Reward, and Survival

Observations and Commentary  
by a Portfolio Manager

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## Do Investors Periodically Seek Return in all the Wrong Places?

It was stated some time ago by Benjamin Graham, long considered the “Father of Value Investing”, that the financial markets (or any market for that matter) in the short run are a voting exercise and in the long run an allocation exercise. The votes thus cast are “yeas” or “nays” motivated by the most common and polar opposite of human emotions: fear and greed.

Collectively, daily market activity can be seen as representing an ongoing debate between these two emotions in reaction to the perceived risks and rewards as they relate to the investment in question. It can be reasonably argued that for the most part, over time, this debate is both orderly and balanced. Sellers, feeling that the risk of their holding(s) at some point outweighs the reward of being held, are easily able to find buyers, who in turn believe that the potential for reward justifies the perceived risk. Quite often this debate can be asset specific in nature, or, as in the case of entire markets behaving as though of one mind, it can encompass an entire asset class, or even collection of asset classes, almost irrespective of the individual components.

It is certainly possible, and the history of markets has shown it quite probable, that the generally rational and balanced debate within any given market can, at certain key points, grow not only increasingly aggressive, but even quite contentious. At the extremes, the smooth running voting mechanism begins to break down as buyers and sellers allow one key emotion to dominate the other. In rapidly rising markets, greed trumps fear in convincing market participants on both sides that the mere phenomena of increasing asset prices somehow improves the chances of even larger rewards, while the perception of risk has all but disappeared. Sellers hold out for and demand even higher prices while the buyer blindly obliges. Contentious debate has actually ended, and what one witnesses is really a consensus between buyer and seller. Any form of market balance has ended. At times, it is the presence of this consensus that helps to mark the end of one dominant trend and the beginning of another, quite opposite trend. Conversely, in rapidly falling or even collapsing markets, an increased sense of fear and self preservation motivates the debate to move toward a heightened perception of risk, where participants are no longer willing to be generous in their respective assessment as to any level of reward. Buyers become more hesitant to buy at the very time that sellers desire to sell at almost any prices. Again, as this market consensus begins to take place, there is much evidence which points to the increased probability that the next major move by the market will be in the direction opposite the consensus. It has been commonly observed that human beings are inherently risk averse. This could help to explain why markets decline at a more aggressive pace than they rise. Studies have shown that market participants are more willing to avoid the potential for a 10% market pullback than to participate in a 20% market advance.

Therefore, in assessing the most recent erratic and somewhat discouraging financial market behavior, the position needs to be explored that the current level of contentious debate is possibly indicative of a market extreme to

the downside. Is it possible that current buyers and sellers are equally blind in their perception of risk and assessment of reward? Could actual asset fundamentals be stronger (or in some cases weaker; witness the behavior in Treasury yields plunging this past week in what felt like a panic driven move toward perceived safety. Somewhat ironic given an after market S&P downgrade on that very same debt) on some level than current price behavior would indicate? As the buyer is guilty of voting “yea” at market tops, could the seller now be equally as wrong in voting “nay” at these market lows? Even more broadly and dynamically, could the growing presence of fear in both the buyer and seller indicate that the markets are close to moving in a direction opposite that consensus?

### “Kicking the Can” – Haven’t We Seen This Movie Before?

In both this year and last, not only have financial markets behaved in eerily similar fashion, but many, if not most, of the issues currently distracting these markets did so last year as well. Two strong market rallies of some duration, each time in the month of May, met with various forms and levels of worry based resistance, triggering at first, some badly needed profit taking. In each year, initial orderly market debate between buyers and sellers had by midsummer turned increasingly contentious as asset prices fell more aggressively. Observations over these past two weeks could argue that market behavior had in fact potentially reached that point of consensus (possible bottom) where healthy, constructive debate no longer existed; both buyers and sellers were voting “nay”, wanting no part of owning most financial assets. In similar reaction as last year, the dollar has strengthened at the expense of the Euro, and commodity prices have collapsed. Liquidity in each case has moved rapidly from the formerly perceived safe-haven status of hard assets to that of the US Treasury market (quite perversely Treasury yields fell for the past two weeks as the twin threats of default and downgrade (rating) did little to discourage buyers) as global investors changed their perceptions of risk, even in the face of very little or no real reward (A/O Wednesday, August 17th, the 10 Yr Treasury was yielding approximately 2.17% which after taxes and inflation most likely would return a negative real rate of return over the length of term).

Behind this recent market action, the fears and worries of the previous year had clearly not gone away, let alone been resolved and in some cases had acutely worsened: the depth and extent of potential European sovereign debt default; doubts surrounding the actual strength of European financial institutions having faced less strenuous “stress tests” and capital requirements than their US counterparts, economic impact of necessary austerity measures both in Europe and in the US, contentious debate within the US Govt over debts and deficits (lacking orderly debate, their global “stock” value has gone down in the eyes of many), renewed recession fears within awkward attempts to grow our domestic economy, fears of commodity based inflation on some level impacting both the US consumer’s

spending habits and US corporate profits. The unknown economic impact from natural disasters in both Japan and the US this past Spring did little to assuage investor fears and doubts about what lie ahead. The global investors' perception of risk, for now, has quite possibly changed toward what investments had successfully worked for most of this past year. With overall Treasury yields at multi-year and almost former financial crisis lows, no real signs of imminent domestic recession, liquidation of most asset categories last week, (including by Thursday, gold, the last vestige of value for many), it is very possible that current investor' perception of risk have been misdirected and therefore needs to be reassessed. More to the point, one year ago, the then Spring/Summer drama forced investors, through fear and uncertainty, to sell off what were far from overvalued equity positions. By August of that year, those same equity markets began what was to be a vigorous nine month rally of over 25% (as measured by the S&P 500). It appears that we may be seeing this year's version of last year's movie. For investors, is the ending the same?

### **Corporate America – A New “Safe Haven” for the Investor**

In stark contrast to the erratic and confidence shaking performance of the US equity markets in these past few weeks, are the strong fundamental underpinnings of the very same companies represented in those markets.

For the better part of the past month, not only have most companies reported strong second quarter earnings, but the majority of those earnings have exceeded expectations (by some accounts over 70% beat Wall Street expectations). Moreover, not only did the aggregate of these earnings show growth of over 20% when compared to the same time frame as last year, but they were also the highest earnings in total ever recorded by Corporate America (it might be wise to note that the S&P 500 is NOT at all time highs). Furthermore, for the most part, corporate balance sheets continued to show that they are well managed, with ample and increased levels of cash, a continuing fiscal discipline toward Spartan or even decreased use of debt, and the ability to finance themselves at ever lower costs. It might be noted that recent weakness in Treasury yields potentially bodes well for further corporate financing or refinancing in the months and quarters ahead. Also worthy of note is the almost utter collapse in global commodity prices (most notably oil) and what this could mean for those companies whose costs are duly and unduly influenced. The inflation and negatively impacted consumer worries of this past Spring could very well disappear in the coming months.

By many measures it can be argued that the entity of Corporate America, since the “Great Recession” has slowly become one of the safer havens for the investor, both global and domestic. Not only have corporate balance sheets become more liquid and less leveraged, but the operating discipline of the ongoing business has kept payrolls and physical inventories at rather tight levels. One only has to look at the current unemployment rate to confirm the general reluctance of many corporations, during these uncertain times, to add additional units of headcount. As a result, net profit margins are at some of the highest levels on record with little evidence on the horizon that this is about to change any time soon, though clearly unsustainable

in a more steady, predictable growth environment. Even our once highly strained financial companies are increasingly seen as being in some of the best fiscal shape in decades with lower and more manageable leverage with almost smothering levels of capitalization. These are hardly the ingredients for those fearing a repeat of 2008.

On a more macro level, Corporate America looks even safer, more stable, and far more capable of rewarding the investor for the risk taken than many of the alternatives. One would be hard pressed to find a corporate entity running annual fiscal deficits, an inflationary monetary policy, and having periodic requests to increase its debt ceiling, all while showing an incredible reluctant toward a reduction in spending. Yet, investors this past week showed no restraint in rewarding the very issuers of the debt securities “backed” by the full faith and credit of the US Govt. Meanwhile, the individual is currently trying to de-lever an overextended personal balance sheet in a less than robust economic environment marked by stubbornly high unemployment, a weak housing market, and occasional commodity price inflation.

So again, it can be postured. Has the investor perceived actual risk in the wrong place(s) and thereby moved away from the reward?

### **Showing the Investor the Cash – Looking for Return in all the Wrong Places**

Corporate profits are traditionally called the mothers' milk for equity investors. As the result of recent market weakness and the aforementioned strong reported corporate earnings, the forward looking valuation of the S&P 500 is at one of the lowest levels in a generation. One would think that on its own, this should be sufficient support to promote higher equity prices in the future. However, this valuation is reliant on a consensus of forward earnings assumptions that must be viewed as valid against an uncertain economic and political environment both here and abroad. Quite possibly in this multi-generational low interest rate environment, where vigorous and sustainable economic growth is being questioned, it could be the more predictable reward derived from corporate dividends which serve to attract the investor back toward equities.

Currently by most measures, when compared to the alternatives (ie 10 Yr Treasury Bond) not only are dividend yields quite generous, but they appear well supported and in some cases, can be, and in fact are raised on a consistent basis.

Therefore, at some level, it becomes increasingly probable that the recent negative market action is suggestive of a now highly risk sensitive and risk averse investor who is looking for return in all the wrong places (again, witness the buying panic into Treasury securities, even with the threat of default and potential downgrade, A/O Wednesday, August 17th, 2011, 10 Yr Treasury yielding 2.17%). Furthermore, now that the daily market debate has moved from a once orderly decline to one where both buyers and sellers appear reluctant to buy or hold (consensus) onto quality assets at any price, conditions may be ripening for the market to once again move against that consensus.

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