

Impressions

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16398 NE 85th Street, Suite 201
Redmond, WA 98052
425.861.0112
dennis@sweetwaterinv.com

Why do smart people do stupid things?

You know, to address crowds and make promises does not require very much brains.

Eduard Shevardnatze

If you want to determine the IQ of a crowd of people take the lowest IQ of any member of the crowd and divide it by the number of people in the crowd.

Harold Eastman Ph.D.

Crowd behavior has been an enemy of investors almost from the first time someone bought or sold something. Good investors learn quickly how to use the antics of crowds for their own benefit. If they do not learn the lessons of crowd behavior they are not investors they have another name - pigeons.

Even the ancients knew the effect of mass behavior with such worthies as Cato the Elder and Plato talking about it. I think the most important books I have ever read on the stock market were **Extraordinary Delusions and the Madness of Crowds**, **The Crowd**, and **Devil take the Hindmost**. Only the last has any mention of the US Investment markets.

Aberrant crowd behavior is not limited to the financial markets, where it is dangerous primarily to money, also occurs in situations that can be physically dangerous such as riots.



It is one of the core characteristics of crowds that when mass behavior takes control seemingly normal, well-adjusted people of high intelligence, morals with no hint of violent or cruel behavior are capable of the most horrific acts.

Totalitarian, collectivist societies tend to use the power of the crowd to overcome the intellectual dishonesty of their systems of government and thereby control their populace. Such actions were and are a staple of the communist regimes.

The reason for all this rambling is that some things have happened that got me thinking about why it is that otherwise smart, respected people do stupid things with money.

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Since the summer, we have witnessed the explosion of several large hedge funds. There was Bayou Capital which turned out not to be a hedge fund but a daisy chain of money wiring. Then there was KL Group who did wonderful things with money except no one knew what they were and they apparently did not work. The last problem did not stop the proprietors of the fund from reaping generous fees at investor expense however.

Of the big failures, my favorite was Wood River of Sun Valley Idaho. Wood River apparently raised \$325 million dollars and was, of course, run by the single smartest human who ever walked the planet. The problem was that apparently whatever this genius was doing it did not warrant statements or even reports to investors detailing anything more than we are still in business don't worry you're making lots of money.

As all things do, Wood River came a cropper when someone tried to take out their money at an inconvenient time and all sorts of things started to fall out. For example the portfolio manager and his family were apparently living in the firm's office space ostensibly because they were building a mansion somewhere in the area. One problem, no such mansion was under construction or even had building permits.

This intellectual powerhouse had three cars, a Land Rover and two Porsches and there seemed to be constant rotation of the cars with one or more disappearing for some length of time and then a new car would appear. There is a word for this:

re-possess 🗣️

Pronunciation: "rE-p&-'zes also -'ses
Function: *transitive verb*

1 a : to regain possession of **b** : to resume possession of in default of the payment of installments due **2** : to restore to possession

The other question I have is why anyone would drive a Porsche in Sun Valley (apparently,

these were not the Cayenne SUV models)? There are copious amounts of snow and ice and driving a low slug, high-powered sports car in such conditions is dangerous and stupid. I guess that if you choose to drive that sort of car demonstrates that you are a master of the environment, you make your own rules. People like that probably ride snowboards, wind surf and sky dive.

The real shocker came when the list of those who were investors in all these disasters came out. It was replete with names of captains of industry, pension funds, corporations, and that wonderfully lingual redundant entity the fund of funds.

These supposedly smart people appear on television and conferences to tell us mortals what is really happening. In the case of the pension funds and the funds of funds, these people are paid to be smart because they are investing other people's money. The real question is with all their deal flow, with all their connections; with all their resources, why the same cast of characters is always present in every financial disaster.



There seem to be several forces at work:

1. **The Pied Piper** we all remember the story of the Pied Piper of Hamelin who was not paid for removing the rats from the town so in revenge he led

the children out of town and into the river, which I guess means that you should always pay your exterminator, exorcist and child care professional.

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In the story of the Pied Piper, the weapon of choice was a magic flute and music, in the case of investment flim flam the magic is greed and words. Americans are unique in the world in that they are always looking for the one big fast hit that will make them wealthy beyond the dreams of avarice. They ignore the fact that the storied successes of the past occurred in far different circumstances such as no income tax, governmental favoritism, or by methods that today would give you a free trip to Club Fed or worse. So greed makes people willing to listen and then the words start.

Promoters of products are very good at determining what it is that you want to hear and they give it to you. They know that if you are in a meeting about commodities that you are there out of fear of the future for financial assets so they play on those fears. Your emotions have half sold the product; they need only to administer the coup de grace (**Like that? That's French. They use that in France, when I use it it shows I have class.** "Edward G. Robinson "Little Caesar")

If you are greedy which, is one of the seven deadly sins by the way, you want to be convinced your greed feelings are justified so you are open to anything that makes you feel comfortable. That leaves you open for the pied pipers of the world. Remember the famous line from the movie Wall Street? Originally attributed to Ivan Boesky it was delivered by the deliciously evil Gordon Gecko as "Greed is good, greed works".

In an effort to assuage guilt feeling investors make a home in their hearts for the pied pipers and usually they are treated as either rats or children of Hamlin.

2. The Lemmings

Just a quick review of your high school biology, a lemming is a small furry member of the rodentia family that lives in Scandinavia. Periodically, and for no discernable reason, a large portion of the lemming population gets together and runs off cliffs to their deaths. With a certain degree of periodicity, investors do the same thing.

Human kind is a social animal, we run in packs regardless of our attempts to differentiate ourselves. We crave acceptance and adulation of some type. Most people are more comfortable being in tune with consensus position than being an outlier. This means that when the herd begins to move in whatever direction it will have huge consequences.

We see this all the time in the investment markets most recently in the two years prior to 2000. We may be seeing it again in the real estate markets in some areas. It is a dual action thing the lemming craze is both on the upside and on the downside so it is at least an equal opportunity way to lose money.

The troubling concept in the lemming behavior is that when the lemmings jump off the cliff they die but in the case of humans when we jump off the cliff of stupid behavior we do not die but we apparently refuse to be educated. The same folks who were chasing the dot com stocks higher in 1999 are now chasing real estate higher in 2005 and claiming that things have changed and it is impossible to lose.

Right now because of the lower returns in the stock market, and low interest rates meaning low bond returns people are looking for "alternative investments" things that do different things with stocks, or bonds, or find ways to link disparate securities together. They are looking for the non-

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correlating assets and it doing so they are creating a lemming like rush to these strange items.

This type of rush is what allows smarmy promoters to raise large sums of money quickly with promises of returns only slightly higher than an index fund but at higher costs and risk. This is “obviously everyone is doing it and if I don’t I will be left out and I will not be loved”.

Being unloved is not the worst thing that can happen but being poor, sick and old can be. I would rather be an unloved lemming than a dead one.

3. The Smart Guys

I am always amazed in the aftermath of some financial imbroglio two characteristics seem to emerge. First, when the records of the promoters are studied, they almost all had shady records that should have warned people off. Usually the records indicate association with firms that have failed amid regulatory controversy, or association with individuals who have done some time as a guest of the federal or state authorities. Or perhaps they have been a party to one of the law’s great dodges the consent decree, where the crook says “Whatever I did I promise not to do it again, and this means I am not guilty.”

The other characteristic that seems to pop up all the time is the number of people imbued by society with supposed smarts who find themselves involved in the fraud. The question is why. After all these are people with more money than God, who have all the resources in the world, and all the connections to others and they still get burned.

What seems to happen is a combination of greed, the pied piper effect and the lemmings. It will be a shock too many when I

say that most people invest not based on what they themselves have discovered but based on what others are doing. As a social animal, we cannot stand to be left out of the group.

At the upper reaches of societies or sub groups of society there exist elites or those who fancy themselves elite, either by virtue of education, experience, inherited social position or attainments. These elites talk among themselves mostly, like the old saying from Boston “ the Cabot’s talk only to the Lodges and the Lodges talk only to God”.

Many of the elites use the same advisors so you will occasionally see a reference to some advisor as ‘advisor to the stars” these advisors then lead all their customers into the same investments and of course we all want to be in the same investments as Barbara Streisand. That is one route for purportedly smart folks to get involved in fraud.

The second way is the connection thing. Many years ago, I had a conversation with AJ Foyt the racecar driver. I asked him how it was possible for NASCAR drivers to drive at 200 miles per hour 4 inches from the bumper of the car in front of them. His response was that it was because as a driver you knew exactly what the other driver was going to do in any situation so there was a high predictably factor and that reduced what appeared to be an insane risk.

Among the elites, there is an illusion of predictability. If you went to an Ivy League college or one of the other acknowledged leading universities, or if you have other connections like crewing on some big racing sail boat the idea is that something is known about you, your actions are to some extent predictable and therefore we know we can trust you. That may have been fine in the old days but in today it is just bunk.

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It today's world with its focus on relative morality and where destructive action is worshipped as free choice, trusting someone you never met because they went to the same school as your dear friend Buffy is dangerously stupid. We have seen the effect of this kind of thinking with some high profile criminal cases where the old boy network prevented justice being done to spare embarrassment for some member of the elite.

One of the people involved in the Wood River fiasco when asked if he had ever read any of the documentation on the fund before investing 10% of his companies retirement plan said "no but I knew other smart people who were involved and I trusted them". I checked, he lost all the money (17 million) and he still has his job. I tell you, this being moral is getting in the way of me being rich.

In the smart people variation of foolishness, investors follow another purportedly smart person to an investment. The real issue here is the transferability of knowledge.

The fact that a person is a brilliant surgeon, a gifted lawyer, a talented writer, a successful politician or wondrous software engineer does not mean that they will be or are successful investors. Knowledge and aptitude do not transfer equally in all directions. We make up many rules about people's actions that are wrong, like the connection between cognition and elocution. Because a person is not a skilled public speaker, does not mean they are idiots and vice versa.

There seems to be, in this most egalitarian of nations, an elite class developing around smartness. People with a high level of cognitive ability are given a pass regardless of their poor socialization, poor bodily habits,

poor manners and antisocial behaviors all because they are smart.

The cognitive elite get a pass in other ways also. Because it is assumed they are so much smarter than that when they make a pronouncement, it must be correct and well thought out and therefore unchallengeable. This is a variation of the political philosophy of the 19th and early 20th century called Fabianism.

How many times have you heard a conversation about investments or a company where the first line is "he, she is so smart" what exactly does that mean or how about one of my favorite lines "he is wicked smart"? The words in that last ought to tell you more about both the speaker and object. What is wicked smart? Are they wicked or smart or does it mean that all smart people are wicked or that wicked people are smarter than moral people?

It is amazing that in a world where we will not judge the consummate evil of terrorism as wicked we will use the word as an adjective to imbue excellence in cognition.

How do I quantify the extra return in my pocket attributable to "smartness"? Smartness used to mean you dressed well. It is almost a put down – he is very smart so we don't need to investigate to see if he is a smart bloody liar. Remember the smartest people you will ever meet will be criminals and liars. Liars need to be smart they have to be to stay ahead of the questions.

The best combination is not smart only it is smart and honest.

The bottom line of all decisions is that you as an individual are responsible for the consequences of your own decisions. The idea that you would lose \$17 million dollars be-

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cause of some elite snobbery and still be employable is unbelievable.

Now following a super investor like Warren Buffet or Phillip Anschutz can have salutary effects on your portfolio as long as you understand and accept their time frame. Following every supposed smart guy will ruin you. Dustin Hoffman's character in Rain Man was smart but he was an idiot savant I doubt many people would follow him given a full description, but if someone said, he is really smart, and a math wiz, but a little odd he would no doubt be a guest host on CNBC and managing several hundred million.

Summing Up

In today's investment climate with the number of options increasing exponentially and the quality of people presenting them decreasing as fast investigation of opportunities is critical to success.

It all goes back to some basics, first have a philosophy of investment and impose some disciplines. Know what rates of return will accomplish your goals and accept the one that provides that rate with the highest degree of repetition and the lowest risk. If you can't discipline yourself, find someone who can do it for you.

Remember the words from Les Miserable:
"Is it simply a game
For rich young boys to play?
The color of the world
Is changing day by day..."

I would rather have a mediocre, honest mentality working for me than a brilliant crook. Smartness is fine but it is not a substitute for honesty, hard work, and common sense. Of course, as one wag said common sense is anything but common.

The Outlook

One of the curiosities of nature is that the female tarantula spider after reproducing morphs back to a state of virginity before next breeding season. Sometimes I think the financial industry has figured out that trick.

Each year end all the pundits get together sometimes in black tie to talk about what happened and what will happen in the New Year. It is always the same names. What is interesting is that when it becomes time to make these predictions no one demands an accounting for the fact that in many cases they were dead wrong, in some cases disastrously wrong the year before and in some cases for many years before. They all become virgins again and all sins forgiven.

Mark Twain once said that history does not repeat itself but it does rhyme and I think that is an important piece of wisdom to remember. No two market cycles are ever exactly the same but in the broad sense there is symmetry in market action that can be instructive but not necessarily predictive. If one looks at the performance of the Dow Jones 30 since the beginning of the 20th Century through 2004 it is apparent there have been several secular bull markets. Each one of these secular events contained within it many cyclical bull markets.

Each one has been followed by a secular bear market of various durations. When, in retrospect, you compare the economic events occurring at the commencement of the bull and bear phases it is easy to see what effects caused the markets to either stop levitating or stop declining. The pattern is very persuasive like the ocean at high tide each wave of bull market takes the indexes high which each valley is less deep than its predecessor.

In 2000, we ended what has to be the greatest bull phase in history, lasting 18 plus

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years and in which the downdrafts of 1987, 1991, and 1994 were ripples. Given that the ultimate causes of the changed market scenario are not apparent sometimes for years after the peak or valley it is very difficult to believe that we are about to start a new bull phase that will propel us to fame a glory after only five years of bear phase.

Bull and bear markets end and begin when there is some reason to believe that the return on dollars at risk will get better or worse. Not all the wishing, hoping dreaming and desiring does the trick. The great bull ending in 2000 did not end because one day everyone got out of bed and said "you know this market has gone far enough, I'm going to go bearish" That might have been part of the tactical issue but on a larger scale strategic view other things will end up being more important.

The challenge is that we at this point do not know what all the issues are or will be. We can surely point to 9/11 and its aftermath for a change in world outlook, and we can look at perhaps a change in the world environment for the likelihood that we will be faced with a long string of very bad natural disasters, which will have worldwide consequences. We can perhaps look at the replacement of the center right governments of the 1980's and 1990's with center left governments in the developed world. Perhaps the long infatuation with stocks and the neglect of commodities has finally swung to the point of extremes. I frankly do not know what the ultimate issues we will face are, and guess what neither do all the anointed smart people you will see in the next few months.

I do know this, something has changed, and we will not know the full extent of the change for a number of years. We have always been cautious investors and in this

changing world with its desire to give a pass to crooks and those in the elites we are not going to change, this is not the time to give up on methods and procedures that have maintained us and allowed us to survive for 31 years. It is not the time for you to start taking on more risk particularly, risk you do not fully understand.

In the next year you will find us attempting to reduce volatility, find and invest in non correlating asset classes, keep our heads while others lose them, to continue to avoid elite thinking (not that we have ever been in danger of being an elite either financially, cognitively, or socially).

We intend to be like the great NFL running back Tony Dorsett who told me once that the key to his success was not his speed, or strength, or athletic ability but his tremendous visual range and ability to see danger. We are looking for danger and opportunity to protect you.

We would be happy to discuss our views in more detail with you if you desire.

New Addition

As some of you know in August 2005 I did something very unusual for me, I took a vacation. I had to go to Albuquerque for a business meeting at the end of August and following that my wife and I took a driving trip to Santa Fe, then to Chama, New Mexico to Taos and finally we worked our way to Denver.

From Denver, we flew to Kearney, Nebraska. No, this was not a mistimed and misdirected pilgrimage to Warren Buffet; our daughter actually lives there with her husband. At the end of August, August 30 to be exact, she presented us with our first grandchild, Harrison Issac Bell.

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Obligatory proud grandfather picture below:



We all wish you a joyous holiday season and a great new year.

Good Luck,
Dennis Gibb

Of course as a good grandfather, I began to corrupt the lad immediately. So, in the first two weeks of his life I took him to the hardware store, the Cabella's sporting goods nirvana, a John Deere tractor dealer and a sports bar to watch a Nebraska football game.

To further Harrison's education, his father and I plan to conduct an experiment on him. We plan to rub various single malt scotches on his gums during teething to determine which has the best numbing effect. I am sure that the American Journal of Pediatric Medicine will jump all over us to publish our research. Of course my son in law and I will have to sample the scotch first to insure efficacy which may be the best medicine for teething!

As we end the year 2005 and begin anew we have enjoyed a time of blessing and joy largely because of our wonderful client base. It has been a good year and we look forward to a 2006-made great by being allowed to be of service to all of you.