Market Dynamics

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Performance Management System

The Future In A Rear View Mirror

**Portfolios heavy with under-performing stocks almost never outperform the market.
Ignat's Law**

**"We see the world through a rearview mirror…
We march backwards into the future."**

Marshall McLuhan

A collection of recent newsletters is available on the web site.

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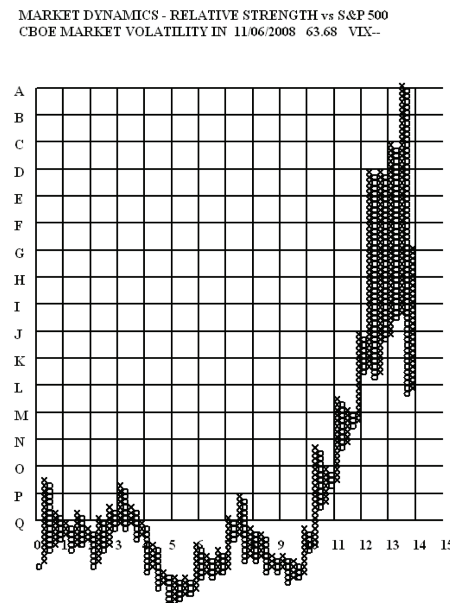
Some years ago, Marshall McLuhan noted that "we see the world through a rearview mirror." That observation seems to be especially important given the current bearish conditions in the stock market.

Investor expectations for the future of the stock market are currently extremely depressed. A well known survey and analysis of the current outlook expressed by investment advisors is at levels usually seen only at major bear market lows. We need to consider whether these advisors actually see a bleak future or are they just reflecting the ugly picture the stock market has painted since October 2007. Experience suggests that the outlook for the stock market is being heavily colored by the recent bad experience.

The image shown in the rearview mirror is a reasonably good forecast of the future as long as the road remains straight. It becomes extremely unreliable when the road starts to twist and turn. This means that investors are prone to miss the important turns in the stock market road. This tendency to miss the turns happens at both tops and bottoms in the market.

The level of emotional intensity shown by investors seems to be much higher at major bear market lows. Fear seems to be a much more intense emotion than greed and the level of fear in the current market is certainly near an extreme. This can be readily shown by an even a casual examination of the VIX indicator. The VIX is at near record levels and is showing dramatic swings back and forth with the daily ups and downs of the stock market. (Additional information about the VIX indicator can be found on the CBOE web site at www.cboe.com)

The extrapolation of our recent experience into our expectations for the immediate future can be heavily influenced by the impact of "social



proof." Dr. Robert Cialdini dicusses social proof at length in his excellent book *Influence* .

Social proof is a behavioral mechanism that people unconsciously use when dealing with uncertain and ambiguous situations. The result is that we often look to see what other people are doing in this situation and then we also apply that behavior. This leads to the herding behaviors that are so often observed in the stock market.

These herding behaviors are at a maximum when the uncertainty and fear becomes intense and that is certainly the case at major bear market lows. We think to ourselves, all of those other investors seem to be selling and they must know something that we don't, so we blindly follow along. The emotional intensity of a serious bear market throws the factor of social proof into high gear. It exerts an almost irresistible pull right at the low of the market.

This element of social proof seems to spread the contagion of fear throughout the market and its maximum force is felt right at the lows. That seems to describe the current situation in the stock market pretty well. We must resist the temptation to join in and let the image in the rearview mirror control our behavior.

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