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Thoughts Galore

The 2003 NFL season officially begins its long track this week. As players begin to prim themselves for the weekly rendezvous, fans too are preparing for the weekly affair. The most arduous, "preparing" fans are usually cappers. Cappers are fans that routinely bet on sports outcome. Religiously pouring over sports articles, statistics, and commentaries, they're always in search of that "edge." The cappers' job uncannily runs parallel to that of investors.

Cappers, however, (although they are fans at heart) have perpetually been tagged with the stigmata of being greedy, low-class, and as a scapegoat for what's wrong with the game today. The justification of this labeling contains a grain of truth – a small grain, however. The allowance of betting on little league games, for instance, is highly questionable. But instances of bad apples are few and far in between. Sport betting is simply: sport betting – nothing more and nothing less. A capper simply bets on the outcome of a sporting event. There is no impurity or shame in such an endeavor.

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I bring up this parallel as a backdrop to another parallel between sport betting and investing. Although the two differ in rules, they both share one intrinsic phenomenon – gambler's fallacy. The concept is best explained by an illustration.

Assume that the Detroit Tigers have lost nine games in a row, what is the probability of the Tigers losing the next game? To a "typical" gambler, the answer is that this probability is less than the probability had the Tigers only lost one game. In other words, the typical gambler assumes that prior event changes the probability. This might make some sense, after all a ten-game losing streak is rare. But this is equivalent to saying that after eight reds have shown up in a roulette sequence, that the next outcome would likely be black than red. This is incorrect, as the probability remains constant regardless of prior outcome. From a "typical" gambler's perspective, it's hard to fathom this. It is easier to believe that the funk (sequence) will be broken up.

This tendency is appropriately called the gambler's fallacy. To some this might be new material, but I imagine that most readers would file this under common sense. But I contend that even these readers don't understand how pervasive this notion is in finance.

One of the most popular screens of stock is finding firms that are trading at 52 week low (or at 52 week high). The notion is that eventually these companies will reverse course. This is tantamount to saying that eventually the Tigers' losing streak will be stop! In other words, the criteria is based on the erroneous assumption that prior event affect the probability of future success. This is a cloaked form of gambler's fallacy. The probability does *not* change; there is no empirical evidence that prior events affect future probability of success.

If probability do change as a result of prior event, then markets are very inefficient. There is an old saying that you cannot pick bottom and top. This is true because the probability of finding a stock (success) that will reverse course is not affected by prior events. To date, there are no consistent bottom and top pickers.

You might argue that a company that has fallen on hard time and is "due" to reverse course. This is equivalent to saying that their probability of success has increase after a "losing streak." This makes intuitively sense, but falls flat after careful examination. The most critical loophole to this argument is one of timing. The firm will eventually (assuming no bankruptcy) turn around, but when? We know that the Tigers will win *someday*. But we don't know when. The question of "when" is what investors are targeting. We know that Kmart will turn around *someday*, but we don't know when.

Moreover, the probability of success still remains the same. Assume that the probability does change because of prior event; we can then safely assume that there must be significant negative autocorrelation. Autocorrelation just mean that prior price can help predict future price. However, negative autocorrelation on stock prices have been shown empirically to be very insignificant. Thus we can conclude the probability of success is not affected by prior event on the basis of observation. If the probability of success did change, it is quite easy for investors to arbitrage away that edge.

(On a side note, this does not mean that technical analysis is worthless. What this mean, however, is that "timing" the end of a streak is impossible. In fact, this is a pro-argument for trending technical analysis. See Vol1No1 for a refresher.)

And yet the 52-week screeners are still heavily used. What is the justification? Some have argued in the name of mean reversion. This is tantamount to saying that prices that are too high must come down at some point, and prices that are too low must come down at some point. Again, the timing issue has not been resolved. We know that price will reverse course at some point, but when? As you can conjecture, mean reversion is not a good backbone to lean on.

Gambler's fallacy is very commonplace. It is in the investor's best interest to step back to view whether or not their strategy is based on this phenomenon.

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Weekly Harbor

Success is a fleeting entity. This is an acknowledged truism in every worldly facet we know of. From the realm of sport to the esoteric world of horticulture, success eventually leads to obscurity. The finance world is no exception. In finance, however, people are not the sole character in the game of success-to-obscurity. Financial concepts, like finance "people," are also subjected to this truism. Take the concept of inflation: once consider the black sheep of macroeconomic is now hailed as a must-needed remedy.

Productivity – the focus of this discussion – has begun to experience the same treatment that inflation went through. Once considered the cornerstone of the New Economy, productivity is now blamed for the lackluster job market. The heat wave of the summer, and likely to continue in the next twelve months, is the economy inability to revive the job market. Productivity is partially to blame.

U.S. productivity last week logged in at a robust 5.7% - well above the consensus 4.6%. Had this occur in the late 90s, the market would have leapfrogged a good 3%. Times has change and success breeds contempt – not in the usually sense. This hike in productivity only exacerbates the already fragile job market.

This is the case because in order for the job market to pick up, GDP growth rate must exceed the sum of increase population growth and productivity. This is self-explanatory. More population growth means more people available to work; thus GDP has to rise to accompany more people. Higher productivity means that goods can be produced with less labor. Thus GDP has to increase further to accompany the "unused" labor.

A productivity rate of 5.7% means that GDP has to rise *at*

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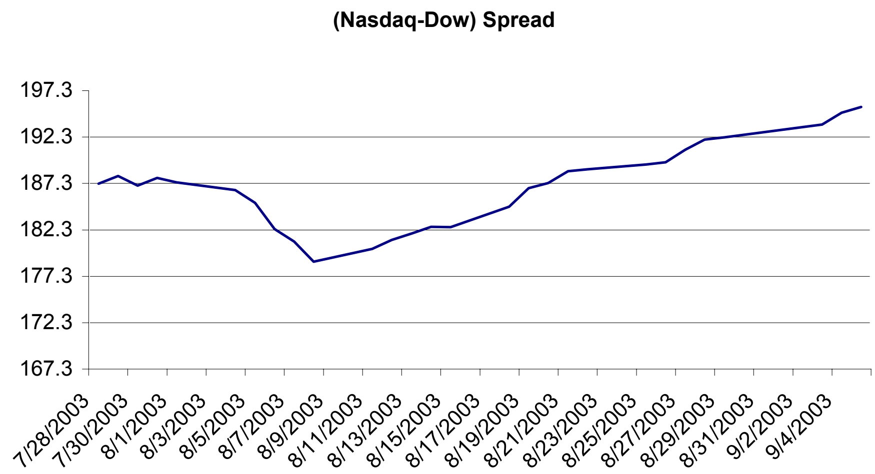
least 5.7%. A very tall order if your country is not named China.

Antithetical to most market "experts" opinions, higher productivity is actually a *good* thing. Although the job market is currently taking a hit, in the *long run* higher productivity benefits employees and the economy. This is an observed fact based on a sound theory. Again known fact: higher productivity *usually* leads to higher wages, which eventually leads to more hiring.

Interestingly, however, current higher level of productivity has not been accompanied by higher wages. Unit labor costs plummeted 2.1% in the second quarter after climbing 2 % in the previous quarter. Adding to this, there is little sign that higher wages are in the horizon. What this tells me as a market observer is that demand for good are not robust as a result of the bubble excess not being completely factored away.

If the bubble excess has withered away, then we would expect that current demand for goods to be robust; in addition, we would expect wages to go up along with productivity. Slumping wages in the face of rising productivity, however, means that firms are expecting in the ***future*** to produce at a level *below* the rate of productivity. If firms are planning to produce *above* the rate of productivity, then wages have to logically increase, as firms will demand more labor and wages will rise. But this is not the case, as wages are lower.

In brief, we can simply examine the robustness of demand by checking the relationship between productivity and wage level. Demand is, thus, not robust by this current observation. Why is it not robust? Simple: the bubble excess has not withered away. Demand is very fragile; firms (contrary to public announcement) are not expecting robust demand in the future. If they did, employment and wages would have rose. That is clearly not the case.



In sum, this current recovery is on very shifting ground.

Does this spell doom and gloom for the economy? Not necessarily. If demand becomes more robust, wages and the job market will pick up. The key is to make demand more robust. How? The economy needs a new stimulus – one of a permanent nature and not a fleeting one. A technological revolution or something along the same line is needed.

The process might take six months or might take three years. No one knows. What we do know is that a permanent stimulus is a must have for a robust economy.

Interestingly, none of this will matter in the short run, as investors are geared towards short-term interest and confirmation. Looking towards next week: Earning season is currently napping. But a slew of economic reports are due out. Tuesday's FOMC announcement will be a key focal point. We also have retail sales on Wednesday, PPI and international trade on Thursday, and CPI and industrial production on Friday.

I see the bull adherents taking next week crown. Economic numbers are bound to look good – no sign of any of these numbers to falter under expectation. Moreover, I think Nasdaq is posed to outperform the Dow. Notice how the Nasdaq lost less ground during Friday session (gains more on good day and loses less on bad day).

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Cash City

Remember as little kids how we would beg our parents to continue trick-or-treating on a neighborhood block despite exhausting all available houses. Begging to retrace our steps – thinking perhaps we bypassed one without knowing it. Or arguing that "unlit" houses are receptive to cute little kids.

Well, in my search for an attractive stock based on cash flow, I have hit a rut. This week, I have been begging the market to throw me a bone. I have even retraced my steps to see if I miss a stock or two that are attractive, while at the same time thinking of "unlit" stocks that might be hidden gem. But most valuations are simply offline. While those with reasonable valuations have elicited little buying interest.

Meanwhile, short candidates are showing tremendous momentum. It's rather foolhardy to short based on valuation alone without any catalyst. Well, currently there is no catalyst. Upgrades after upgrades are pouring in. Sickening if you're a short seller.

I think the waiting game is in order. However I will make these following observations: It is a matter of time before energy stocks become the talk of the town. Valuations are very, very attractive. But buying interest is simply nonexistent. On a different note, a correction for tech stock is inevitable. Some tech stock will due reasonable well, but a vast majority are bound towards zero or at least in the teens. Valuations are sick. Nasdaq P/E ratio is currently well above 70. I simply do not seem the justification. But again, there must be a catalyst. I'll sit on my hands until then.

Well, I figure I take the time to review previous stock selections. All, to my glee, are doing admirably well – logging returns in the black. Compared to the S&P 500, the results are little mixed. But that is to be expected, as the long candidates are low beta stocks. While the lone short candidate has held its own despite the recent run up. The table is self-explanatory.

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Author's Note

A rather humdrum week. Not much to comment on. The next six to twelve months should jumpstart the thinking train. This week lone excel file is Summary.xls. Located as always in the Download Section.

SBC	**8/3/03**	**9/7/03**	**Return**
Position: Short	$23.40	$23.00	**1.74%**
Benchmark: S&P 500	980.15	1021.39	4.21%
GTSI	**8/10/03**	**9/7/03**	**Return**
Position: Long	$9.11	$12.02	**31.94%**
Benchmark: S&P 500	977.59	1021.39	4.48%
BBI	**8/17/03**	**9/7/03**	**Return**
Position: Long	$19.16	$21.16	**10.44%**
Benchmark: S&P 500	990.67	1021.39	3.10%
FNF	**8/24/03**	**9/7/03**	**Return**
Position: Long	$29.13	$29.42	**1.00%**
Benchmark: S&P 500	993.06	1021.39	2.85%
FAF	**8/31/03**	**9/7/03**	**Return**
Position: Long	$24.18	$24.33	**0.62%**
Benchmark: S&P 500	1008.01	1021.39	1.33%