WILLIS INVESTMENT COUNSEL
Principled Investing

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PRIMARY MISTAKES INVESTORS MADE DURING THE LAST FIVE YEARS

Not the financial crisis, not Europe, not the fiscal cliff, but extrapolation and pessimism

OVERLY-PESSIMISTIC

Among the primary investment mistakes investors made over the last five years was remaining overly-pessimistic and overly-reliant on forecasts. Excessive pessimism (yes, perhaps this is a bit 20-20 hindsight) was the natural reaction following the 2007-2009 dismal experience that caused many to lose faith in the markets, in the banking system, and perhaps even in America's capitalism. It became increasingly easy to remain pessimistic because there were abundant and relentless headlines and forecasts reinforcing fear and pessimism. Few investors realize the fact, and fewer still consider and apply the fact, that economic and market forecasts are usually unreliable. This does not refer to the well-known dangers of "market timing". Rather, it is the poor forecasting track record of economists, market prognosticators, Wall Street's strategists, and investment advisors that does not get reflected in decision-making. Even though solid empirical data tells us such forecasts are usually off-the-mark and unreliable, Wall Street and investment advisors base strategy and portfolio management decisions on those forecasts. Because that increases risk, we do not rely on forecasts.

RECOVERY IN PORTFOLIO VALUE MISSED BY MANY

There is reliable data that indicates many have failed to participate in the market's recovery. Most would conclude the market's recovery since its March 9, 2009 nadir has been remarkable, even extraordinary. We believe it has been unremarkable and ordinary. History tells us markets are usually mean-reverting. Sharp declines are usually followed by sharp recoveries. Economies heal. Excesses get absorbed. Equilibrium gets restored. That is just how capitalism and Adam Smith's invisible hand works. This view sounds too simplistic doesn't it? Our partner Wendell Starke has cautioned us to be careful when talking/writing in such a "simplistic manner". He is right when he reminds us that a "sophisticated, informed" view must (i) emphasize the insurmountable problems, list the headwinds, (ii) be negative and avoid sounding positive, and (iii) not come across as an optimist that believes in the natural healing powers of our capitalistic economy and markets. Decades ago the Austrian economist Joseph Schumpeter said much the

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same thing "Pessimistic visions about almost anything usually strike the public as more erudite than optimistic ones". We will just have to risk being viewed as unsophisticated and uninformed because we do believe the economy and the markets are mean-reverting, excesses do work their way through the system, and companies recalibrate and adjust to the changing environment – they not only do, they have.

In our view, the exodus from stocks into bonds has continued for almost five years as many are simply extrapolating the past and failing to accept the economy is healing, markets have stabilized, and company valuations are very attractive. We believe it is far more reliable, and less risky, to focus and base decisions on valuation than on economic or market forecasts.

CORRECTIVE PRESCRIPTION

WIC's advice: Ignore the noise, the urgent headlines, the hyperbole, and the forecasts. Accept the fact that the economy, the banking system, and the markets, etc. have sufficiently stabilized. Their risk is now acceptable. Recognize and accept the historical fact that the *resilience of the American economy, capitalism and the markets works*. That is the story of the last five years. Company/stock valuations are more than acceptable meaning the all-important risk-reward trade-off is now more than acceptable. Therefore, a substantial portion of excess cash should be allocated to equities. If a defensive tact is still needed or desired to "sleep at night", that is exactly what WIC's *Managed Volatility and Income Strategy* that emphasizes dividends and downside protection is designed for. See "Managed Volatility and Income Strategy" on our website at www.wicinvest.com.

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For more commentary, we invite you to visit our website at www.wicinvest.com.

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