INVESTMENT UPDATE
NEWSLETTER

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Suspending Disbelief is Not Fiduciary, Even When Profitable

Ever know someone who focused on what was wrong with a movie instead of just enjoying it? I had a friend like that back in school. Plot inconsistencies, boom microphones bobbing at the screen's edge, hokiness in the special effects, or any hint of the benevolent subtleties and contraptions which moviemakers gin up to help audiences have a good time – these seemed almost to delight him, intent as he was on identifying signs of artifice and *denying* the spell that normal people buy their tickets to fall under.

I feel differently. When we go to a play or a movie or even a kids' magic show, we must willingly suspend disbelief. Indeed, giving ourselves over to an acknowledged fiction can be the heart of entertainment.

Problem is, lately I've been sounding more and more like that guy when I talk about the markets and the economy, though I think I do it with far less relish (certainly I do it with more trepidation). I don't like to sound that way. But there are too many plot lines that don't agree, frayed wires I see holding up the props, and dialogue that doesn't ring true. Altogether, the recent stock market rally is a production that lacks verisimilitude.

Among what's troubling me:

- The markets' growing tendency to treat bad news as good news – no clouds, just silver lining (e.g. "rising inflation shows that QE2 is working")
- Brushing aside data that doesn't conform to the bullish bias (as if caring about falling home prices is old hat)
- Focus on positive-sounding headlines to the exclusion of negative underlying details (the headline: Consumer Credit Growing Again; the details: every measure of consumer credit keeps falling except for areas dominated by government subsidy)
- Celebration of positive surprises that is not followed by a commensurate retreat when the positive numbers are later revised out of the data (notable in unemployment series particularly)
- The co-existence of opposing forces (cycle-high profit margins vs. input costs rising faster than retail prices)
- Central bank policy that resembles nothing so much as a side alley shell game (in 2011, the Fed increasingly buying *newly issued* Treasuries)

Should it matter? If stocks are going up, shouldn't I just "sit back and enjoy the movie"?

For fiduciaries, investment isn't entertainment. We can't suspend disbelief even when it might be temporarily profitable to do so. We have to treat fiction as fiction – a spell that won't last, no matter how enjoyable. Likewise, betting on the duration of the spell is speculation. In all, we believe contrivance in the capital markets is not benevolent, but a source of distortion and inefficiency, and eventually, of pain.

One last thing to emphasize: There will come a time when I'm fretting that the market is ignoring *good* news buried in the details and focusing only on the negative. Which will be OK – when the crowd jeers at optimism, you can buy knowing that prices carry a margin of safety to support your effort; i.e., you can afford to be wrong. When caution is what looks foolish, that critical margin probably isn't there, and you can't afford not to be right.