RGA INVESTMENT ADVISORS, LLC

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The Market at an All-Time High

Last month, we pointed out the significance of all the major market indices (sans the NASDAQ) surging to record highs. April was an interesting month in a very different way. While the major indices digested their gains, there was absolute carnage in the commodity space. Most notably, gold, the safe-haven of choice for investors over these last few tumultuous years, shed 7.57% on the month. In one day alone, gold lost 9.6% of its value. Many continue to blame the decline in gold on some sinister plot or dismiss it as a warning sign for the broader economy. We think these explanations are far more indicative of the "religion" around gold as an asset, than it is of something meaningful for the economy; we discussed this in our February 2013 Investment Commentary. To that end, we attribute the decline in gold to two important forces: 1) gold's failure as a safe-haven during the worst of the Euro crisis, during which the price actually declined; and, 2) the market's continued resilience at all-time high levels. Today, we would like to focus on this second point and what it means for the broader investment environment.

First, a necessary digression: we are pleased to say this is the first time in the history of RGA Investment Advisors with the U.S. stock market in milestone, record high territory. This company was founded amidst the biggest financial crisis since the Great Depression and we take pride in how we have navigated through what even the most experienced sages of market wisdom declare as one of the least forgiving, most challenging investment environments ever. We promise both to you and ourselves that these years will serve as an important lesson in patience, strategy and humility, for we all know that while today the market giveth, it can just as easily taketh away.

We are self-reflexive at this moment because we think it's important to be cognizant of the many emotions induced by the market over time. Further, we constantly want to learn more about how and why the market does what it does from a behavioral perspective, and to that end, have studied the great thinkers in that arena. One particularly intriguing school of thought is Prospect Theory, which we have introduced in commentaries past. Investopedia defines prospect theory as "A theory that people value gains and losses differently and, as such, will base decisions on perceived gains rather than perceived losses. Thus, if a person were given two equal choices, one expressed in terms of possible gains and the other in possible losses, people would choose the former."[1] To that end, it is the study of how people make probabilistic decisions when there is a degree of both risk and reward, and it holds that people are more sensitive to losses than they are to gains. In other words, the pain from losses leaves a more profound impact on the human psyche than the pleasure derived from gains. This idea was introduced by Daniel Kahneman and Amos Tversky in 1979 in a paper entitled *Prospect Theory: An Analysis of Decision Under Risk*[2] and has been expanded upon ever since.

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[1] http://www.investopedia.com/terms/p/prospecttheory.asp

[2] http://www.jstor.org/discover/10.2307/1914185?uid=3739808&uid=2&uid=4&uid=3739256&sid=21102235131477

A corollary of Prospect Theory is an idea known as "the disposition effect." This idea holds that people sell stocks that have gone up far quicker than stocks that have gone down. The disposition effect is closely tied to the concept of "myopic loss aversion" covered in our January 2013 commentary. Why are these ideas relevant today? Interestingly, the disposition effect has particularly strong consequences with markets in all-time high territory, and we feel it is important to review them in light of today's investment environment. Since people sell gains quicker than they do losses, there is a greater propensity for selling above all-time highs than below. Therefore, when markets are at all-time highs, selling pressure tends to increase, leading to greater portfolio turnover in Bull than Bear markets.[3]

Drawing this out further is the important idea that loss aversion does not exist in a vacuum, and as such, there is a reflexive relationship between the success (or lack thereof) of prior decisions and the nature of present and future decisions to be made. For the typical investor, "after prior gains, he becomes less loss averse."[4] In other words, people are most risk-seeking after periods of success and most risk-averse after periods of failure. Meanwhile, prudence would dictate practicing the converse. This pendulum of risk tolerance fluctuates back and forth dependent on the most recent market action. Collectively, these ideas relate to another concept we have long discussed—the notion that people fear a crisis most in its aftermath, rather than its inception. It is thus no surprise that some of the biggest doomsayers in today's press are those who were caught most off-guard by the crisis in 2007-2009.

So where do we stand today on this sliding scale of risk aversion? We think it remains clear that investors have been severely impacted by the recent crisis. Investors are so risk averse in today's environment, that in aggregate, they would rather flee into the perceived safety and certainty of returns in bond markets, while simultaneously ignoring longer-term bond market risks and foregoing a more reasonable tradeoff between risk and reward in equity markets. Despite markets making all-time highs, there remains a healthy skepticism, and even anger, at the very fact this is happening amidst what remains an economy performing closer to trough than peak levels.

As always, we continue to make our decisions based on our sensitivity to price in each and every individual investment that we make, though we are equally cognizant of the sentiment towards risk and reward around us. When markets are making highs, so many want to be "the one who called the market top" yet we can assure you of only this—on the way up there will be many tops before there is THE top, and it is our belief that through prudent bottoms-up fundamental analysis and disciplined asset allocation we will best insulate ourselves from the type of risks that were borne out in 2007-09.

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[3] Notes from Nicholas Barberis at Sante Fe Institute's *Risk: The Human Factor* conference. http://compoundingmyinterests.com/compounding-the-blog/?currentPage=2

[4] http://forum.johnson.cornell.edu/faculty/huang/prospect.pdf

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Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail. Please feel free to call Jason or Elliot directly at 516-665-7800.

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