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# The Mood of the Market

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Given the volatility of the current market, we've returned to three distinctions we utilized in 2000 when managing wealth during the bursting of the internet bubble.

The distinctions are: 1) emotional reaction, 2) pervasive mood and 3) economic and company-specific fundamentals. We define an emotional reaction as a market over-reaction that can be either positive or negative. These reactions are usually fickle, short lived and based on looking at part rather than the whole economic or financial situation. Investors often assume that the current issue is critical, long-lasting and perhaps permanent. During the 2003-2007 bull market there were multiple opportunities to "buy the dips" as investors emotionally sold the bad news of the day. In each of these moments it paid to go against the herd.

The second distinction, a pervasive mood, is deep, widespread, long-lasting and mobilizes people to affect policy makers. A pervasive mood, positive or negative, generates a background assumption that often is the basis for taking the wrong actions. For example, the previous assumption that house prices will rise, combined with the regulatory incentives that made such an interpretation "guaranteed", led to a widespread expectation by borrowers (and maybe everyone) that their real estate assets would increase faster than their payments would. The current assumption that all mortgages, whether in good standing or non-performing, are worthless has led to a widespread discounting of assets that in the long run will prove to be more reliable and valuable than now assessed.

We have successfully used these distinctions of assessment and action to build and secure wealth. Specifically, when company and economic fundamentals are positive and the pervasive mood is either neutral or positive, negative emotional reactions provide excellent opportunities to bet against the crowd, or rather move against the herd, either buying or selling in a contrarian manner. This works very well when markets are basically rational but interrupted by intermittent irrationalities due to emotional reaction. It is this approach, or rather the wisdom and courage to act against the emotional pull, that separates an experienced investor from the novice or lucky one. Unfortunately it is not enough if the pervasive mood is out of synch with the economic/company fundamentals.

Currently, the market has become irrational due to a pervasive mood, not merely an emotional reaction. This pervasive mood and the policies adopted in response to this mood are now impacting the real economy. By real economy, we mean not merely stocks and bonds but the ability of companies to make, buy and sell. This then feeds back to asset prices, business and consumer behaviors, thus reinforcing assessments and actions that support the pervasive mood and complimentary actions. This vicious circle of selling begetting more selling is where we are now. We are in a selling market, sustained by a mood and its related actions that remain unchecked as the circle feeds itself. This cascade will end at some point. Until it does, the way to preserve the scarce resource (capital) is to join the herd and to sell all

the way down. In short, the market can stay irrational longer than many investors can stay solvent.

Over the course of 2008 we have raised cash substantially to near 50%. We hope this is the wrong trade and that markets will resume their uptrend. However, when facing a pervasive negative mood we think it is more important to preserve capital than risk picking the exact bottom. This strategy preserves our ability to act when the vicious circle turns to a virtuous circle. This will happen, suddenly and without notice, except to a few who are monitoring the interplay between these three distinctions. The goal is to preserve capital so that we can play when it is clear we can win the game and when the crowd is in an emotional response that will no longer affect the underlying economic and business financials. When the affects are already known, and the uncertainty diminished for those who are not ruled by their emotions, then the game tips into favor for experienced investors who understand the fundamentals.

The emotional reaction and the pervasive mood always overreact as we're experiencing now. The key is not to know how long a pervasive mood will last but be able to identify and move quickly when the shift occurs before the herd follows. You don't have to be the first to move on the shift, but you can't be the last.

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