

Don't Get Eaten by the Honey Badger

*"An investment in knowledge pays the best interest."
Benjamin Franklin*

From professional athletes to workers standing around the water cooler, it seems that everyone is talking about the callous behavior of the honey badger, an aggressive member of the weasel family. The honey badger's name is derived from its fearless approach to raiding beehives; however, despite its name, it is primarily a carnivore with strong defensive mechanisms such as thick skin, sharp claws and powerful jaws. The honey badger is anything but a picky eater. The animal is adaptive and will take advantage of almost any opportunity to fill its belly, typically at the expense of others. Its diet includes birds, eggs, rodents, turtles and snakes (even highly venomous snakes such as cobras), among many other things. If you haven't determined where this is going, let us assure you that there is a financial parallel.

As advisors, it is critically important that we remain informed and continuously build our knowledge. This requires our team to be plugged in to the demands of investors and the financial industry's response to these demands. Now, before we bridge the gap and mistakenly label the entire financial industry as a group of carnivorous weasels, we want to clearly state that this is not our intent because it is not the case. We do believe that much of the business conducted in this industry is done so with good intentions. However, there is no doubt that a part of the financial industry has mastered the concept of profiting from the environment, just as the honey badger has mastered the art of being adaptive - eating whatever is presented to them as their next meal. We do not have the ability to eliminate the existence of financial industry honey badgers, but we can do everything in our power to ensure that you are not their next meal.

To determine the segments of the investment markets that have performed well in recent years, all one has to do is listen to financial commercials. Are stronger performers in recent years more likely to outperform weaker performers moving forward? No, but it is obviously easier for the financial industry's honey badgers to sell stronger recent performers since most investors don't understand the impact of price-to-value ratios on future performance. In addition, those who do understand the fundamentals of price and value often allow emotion to overtake better judgment during frustrating periods. They convince themselves that it will be different this time and jump into the pool of prey, which only adds to the honey badger's menu of available targets.

Those who listen to CNBC on SiriusXM satellite radio clearly understand what has performed well in recent years (*i.e.* gold). We have not taken a formal tally, but it seems that at least half of the commercials on CNBC (SiriusXM) are gold commercials. Gold started its historic march in 2002 after many years of flat, frustrating returns. During the 25-year period that ended in 2001, gold returned just 3.3% per year, and for the 10-year period with the same ending date, the return was -2.6% per year. At the time, most investors would have scoffed at the idea of buying gold. Needless to say, gold commercials were non-existent then. However, with a gain of 450.9% from the beginning of 2002 through year-end 2011 (18.6% per year), it is now the most popular investment in the marketplace. After reviewing this information and the chart on page 3, do you think gold

is likely to remain a top performer over the next 10 years? Of course, anything is possible, but it is unlikely given the higher price that will serve as a starting point.

Other examples of this situation include Technology stocks in the late 1990's, Real Estate securities during the middle portion of the past decade, oil from 2007 to 2008, and it seems the list is expanded every few years. In each case, the financial industry's product creating machine worked overtime in an attempt to profit from the explosion of demand, and the level of advertising employed to sell these products followed suit. Ask yourself, "How did investors fare who bought Technology stocks in the late 1990's? How about those who bought high yielding mortgage instruments during the housing buildup? Oil futures in 2008?" The honey badger's dinner invitation is alluring, but guess what (or whom) they expect to be the main course?

The financial industry's honey badgers are also adept at profiting from the frustrations of investors. Stock investors have suffered through a difficult 11+ year period where flat, frustrating returns have left many investors questioning even the most basic investment fundamentals. As is the case with gold product creation and advertising, the industry is hard at work creating and selling products that promise to deliver higher returns. Given the level of frustration with stocks, this has been an easy sell. We see it playing out daily in the world of financial advertising. Financial industry honey badgers disguise themselves as the good guys, stating that long-term, buy and hold stock investing is the real predator. After a 20 second summary of why it makes sense to dine with them instead of being a fundamental investor, some investors take the bait.

For example, consider the explosion in variable annuity demand in recent years. Frustrated investors are willing to trade a portion of their future gains to guarantee a minimum return over a contract period. Simply put, they are buying insurance on their investments. Makes sense, right? Well, only for certain investors. One thing we have learned in our years in the investment business is that insurance company forecasters are some of the brightest people in the financial industry. They know that stocks are more likely to perform well after a difficult period. They also know that investors are more likely to demand guarantees on their investments after a difficult period. This scenario sets up the optimal environment to sell products with guarantees that are highly likely to occur naturally (due to stronger investment returns) and have strong profitability for the seller due to the fees charged for the guarantee. While variable annuities are appropriate for certain investors, demand should not have reached the level it has reached in recent years, where the environment has been a primary driver of that demand.

Investors make more mistakes during frustrating periods. They look for creative solutions to improve their situation instead of exercising patience. They often sell the investment that has frustrated them at the wrong time, at a low point, as it is poised to recover (due to attractive price-to-value metrics). For frustrated stock investors, now may be the wrong time to run to alternative solutions such as frequent trading or options strategies where the chance of success is marginal at best. Stocks were overpriced in the 1990's, but sub-par returns over the past 11 years appear to have corrected the disparity between price and value, so it is likely the next 11 years will more positive than the last. For those whose level of frustration leads them to believe the overall stock market is the honey badger, eating its prey in an uncaring manner, consider the fact that the 30-year return for the S&P 500 Index (a diversified basket of stocks) as of December 31, 2011 is 11.0% per year. The lowest average yearly return for the Index over a 30-year period ended in 1958, with a gain of 8.5% per year. Retirement investing is not a 10-year endeavor. Investors who start saving early could own stocks for 50+ years if their risk tolerance, goals and financial position allow for it. *Of course, the allocation to stocks should decline over time as their window of time for recovering loss narrows.*



Conclusion

Financial advertising content would not continue to be filled with gold and active trading commercials if investors were not taking the bait (demanding it). However, at this point in history, after a tremendous gold run-up and a frustrating period for stocks, is now the time to bet heavily on gold and against long-term fundamental investing in the stock market? History would suggest that buying assets after explosive price run-ups is a poor investment decision.

We want to restate that it is not our intent to label the entire financial industry, of which we are members, as a group of carnivorous weasels. We have no problem with those who make a reasonable profit on products and services that are truly in the best interests of clients over the long-term. However, those who take advantage of demand created in certain market environments by selling popular, but potentially unsuitable, products and services (without evaluating what is in the best interest of clients over the long-term) are performing a disservice. Financial industry honey badgers do exist and they care more about their success than yours. In order to avoid their dinner invitation, it is important to build your knowledge, understand the impact of value on price, expect frustrating times, and exercise a great deal of patience. Given the embarrassing level of education offered by our industry, the pool of prey for the honey badgers will be large enough without you in it.



Sources: Gold data - <http://www.goldprice.net/historical-goldprices.php>; <http://www.onlygold.com/TutorialPages/PricesY2KFS.asp>
S&P 500 data - <http://www.standardandpoors.com>

Market Comments

Several of the challenges that resulted in a powerful flight to quality in the 3rd quarter persisted in the 4th quarter, but the investment markets enjoyed a modest recovery from the 2011 lows reached in October. The Russell 3000 Index (total U.S. stock index) gained 12.2% for the quarter and the MSCI AC World ex-US Index (broadly diversified foreign index) gained 3.7%. The primary drivers of positive results for the period were attractive equity prices in general, anticipation of better economic results, and a correction of what many believe was an overreaction in the 3rd quarter.



European debt and the potential for austerity measures aimed at correcting the problem continue to be the main concerns of global equity investors. However, as of the writing of this commentary, some grass roots confidence supported by strengthening U.S. economic data and better news out of China have economists questioning the degree in which decoupling can occur. In other words, to what degree will Europe's problems affect the rest of the world – enough to cause a global recession or to a lesser degree due to the relative strength of other economies?

The bond market continues to benefit from the lackluster demand for equities and tame inflation, which is allowing central banks to keep interest rates low. Of course, low rates are negatively impacting the interest earned on bonds, but the stability in rates is helping to avoid the negative impact on bond prices that would likely result from rising interest rates. Bond fund managers are carefully monitoring the economy in an attempt to forecast the impact of economic activity on interest rates, but at this point, it appears that higher interest rates (as a result of Central Bank action) are unlikely in the short-term.

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