# Aspera Bulletin

Intelligent, Independent Investment Management

## The Idiot/Genius Cycle

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Aspera offers independent fee-only investment management and advisory services throughout the Triangle area and nationwide.

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919-622-2076
Cary, North Carolina
ken@asperafinancial.com

One of the characteristics of my investment discipline is that I tend to be early. I'm early on the way in, and I'm early on the way out. It comes with the territory when you have a strong contrarian bent, and I wouldn't have it any other way. It helps minimize the risk that we take. We take risk when we're paid to do so (valuation is attractive), and we don't wear out our welcome by trying to time price peaks (which is impossible anyway).

Another key trait is that I don't waste any energy worrying about what other people are doing with their money. My Mother summed it up nicely during my adolescence every time she asked, "If Mark (real names have been changed to protect the innocent) jumped off a bridge, would you?" Granted, I found it difficult to answer this question without knowing how high the bridge was, how deep the water, how fast the current, or whether there were any girls around to impress. It always comes back to risk versus reward, doesn't it? The point is that her message was spot on. Mark was an idiot, and I should find new friends. Her secondary point was also correct. Don't do things just because other people are doing them. Think for yourself.

There is a cycle that follows from this investment discipline and these traits. I call it the Idiot/Genius cycle. It helps to illustrate where we are in the lifecycle of an investment, whether it's the overall market, an asset class, a single company, or an industry position. It goes something like this:

### **Phase 1: Ken is an idiot.**

In the first phase, I'm very bullish about a position that is out of favor. No one wants to hear about it, including other professional investors. As soon as I mention the idea, some of them just glaze over, some suddenly remember a previous engagement, and others fake seizures. People avoid making eye contact with me and feel sorry for my wife. Jim Cramer hates the idea.

### **Phase 2: Ken is an idiot-savant.**

Some time has passed, and the investment idea is starting to get a little respect. It has stopped declining and we may even have a modest gain. The idea is even starting to get a little press. A few Wall Street analysts have turned positive, and CNBC is no longer openly ridiculing it. We are probably done adding to the security and have what I would consider a "full" position. Most people are once again comfortable socializing with me. Jim Cramer still hates the investment.

**Phase 3: Ken is fairly sharp.**

By now, the security has performed quite well. More analysts are catching on and upgrading the security. I overhear a couple people at the gym talking about what a great buy it is. My wife is once again comfortable socializing with me and has stopped referring to me as “her current husband.” Jim Cramer is warming up to it. I’m getting a little nervous.

**Phase 4: Ken is a genius.**

The stock has had a terrific move from the bottom. CNBC runs a special segment on the idea and brings 8 experts on the show to “debate” the idea. They all love it. Once strangers find out what I do for a living, they start pitching the idea to me. My local newspaper runs a glowing article on the investment, and it also appears in Fortune magazine as one of the best picks for the next decade. People are actually jealous of my wife (Ok. I made that part up.). Jim Cramer has a son and names him after the security’s stock symbol.

**Phase 5: Ken is an idiot.**

The investment is now too expensive, and just about all of the good news is reflected in its price. There is now much more risk than reward in the position. I sell it. Since I just sold “one of the best picks for the next decade” and a sure-fire winner, I’m back to being an idiot. My single friends start hitting on my wife in front of me, and I go back to playing scrabble online against the computer. How quickly we fall.

**Phase 6: Ken is a genius.**

Eventually, the investment peaks and rolls over. Growth slows, competition increases, profit growth falters, it becomes too expensive, and there’s no one left to buy it. The rats flee the sinking ship. I find new friends, and my clients rename their first-born male and female children after me.

Clearly, you need some self-confidence to survive this cycle because you’re an idiot for 2 of the 6 phases. In actuality, these idiot phases are critically important in terms of my investment strategy and discipline. They are also the reason I spend so much time harping about the need to focus on the long-term and why I caution that we will (and must) underperform at times in the short-term. It must be understood that I will appear to be an idiot for a good portion of the time that I’m responsible for my clients’ portfolios. It’s by design, it’s inevitable, and it’s a key driver of long-term performance.

There is no definite time frame for each phase of the cycle. Phases can occur very rapidly over a span of days or weeks, or (more likely) they can stretch over months and years. Understandably, I prefer the idiot phases to be brief, but I have little control over that. Fortunately, I’m often most comfortable in this phase as it offers the best opportunity to get positioned for the ensuing more enjoyable phases. The beauty of the idiot phase is that you have the genius phase to look forward to. The problem with the genius phase is that you know you’re invariably headed back towards idiocy.

Now, let’s look at this Idiot/Genius cycle in terms of the overall stock market this year. We were in Phase 1 (idiocy) back in February and March when I was adding risk at the height of fear with the market making new lows. This was not a popular move at the time, but the upside relative to the downside was very attractive. Phase 2 through 4 actually happened much quicker than I expected. In all, the first 4 phases took a remarkably short few months. So, while I was an idiot for just a few weeks, I wasn’t able to bask in the glow of my genius for very long. I’ve been largely unwinding risk and getting more conservative since May. The market, however, has continued to power ahead. That currently puts us squarely into Phase 5 – the second idiot phase.

The media, Wall Street, and the small investor are once again bullish on stocks, convinced that we've entered the next secular bull market. I am once again a relatively lonely contrarian voice. Where most see a new bull market, I see a potentially monstrous head fake. Where others see economic green shoots, I see stagnation and structural imbalances which will take many years to rectify. Where others see strong and aggressive fiscal and monetary policy, I see the creation of new unsustainable bubbles and future crises.

Although we are in uncharted territory, history is a wonderful guide when it comes to investing. Most every large market decline in the past has been followed by a vicious and temporary rebound. That doesn't guarantee that the current rally must play out the same way, but it's certainly something to be very mindful of. More importantly, the fundamentals just aren't in place to justify a new secular bull market. Valuation is not compelling, sentiment is too positive, balance sheets are far too indebted, global excess capacity is abundant, income growth is absent, pricing power is negligible, and interest rates are unlikely to fall significantly, just to name a few of the headwinds we face. Despite the present euphoria in the market, the proper course of action for the time being is to focus on wealth preservation and make sure that our portfolios are intact for the next phase 1.

So, for the time being, I am once again an idiot but an idiot by design and a very comfortable idiot. I doubt the cycle has ended, so we do have phase 6 to look forward to. Until that time, my social calendar remains fairly empty, and my scrabble skills are once again improving.

Best,

Ken Bell, CFA, CFP
President
Aspera Financial, LLC

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