

THE “FEAR” TRADE AND HOW IT AFFECTS YOU

By Ken Stern, Managing Director

A few years ago, Americans were facing serious issues: high unemployment, a real estate depression, fiscal deficits, population growth issues such as food inflation, trade imbalances and more. Today, we have many of those same issues. To be clear, some Americans have grown their wealth over the last two years, the stock market has enjoyed an unprecedented bull run and optimism has steadily climbed. Yet, while the markets and personal wealth may be higher, deficits at both the State and Federal levels are, too. Over the past two years, commodity prices are markedly higher—energy is up over 100 percent, cotton

is up over 400 percent. These facts, along with other economic data, have many fearing that we could be entering a period of both inflation and slow economic growth, potentially accompanied by higher interest rates and high unemployment. This combination, often referred to as “stagflation,” hasn’t been seen in the United States since the Carter Administration. That last period of stagflation started in earnest during the oil embargo of 1973, which was a period marked by high unemployment, high gas prices and low corporate profits.

HAVE A PLAN IN PLACE NOW, AS ACTIONS ARE FAR MORE VALUABLE THAN REACTIONS

I often ask myself if it’s still possible to create wealth under these circumstances and, if so, how? What’s the strategy for doing so? I believe that, yes, it’s still possible to create wealth. I believe that the “easy money” in this Bull market has been made. Now, I believe that Execution, Strategy, and Planning will be essential in creating wealth. I like to call this trilogy financial “E.S.P.”

But, even using financial ESP, how do you go about investing with so much uncertainty? Whether you like it or not, there is always uncertainty in investing, but your goal is to invest when you feel that the odds are in your favor. What factors should you be looking at to make this assessment? What time period are you looking at? Most importantly, what are the margins of

error involved and is the upside potential greater than the downside risk?

First and foremost, you must have strategy. I embrace a few key strategies. Using quantitative screening allows me to remove a large emotional component from my decisions. For example, if I only want to invest in companies that have had increased sales over a certain percentage, I can eliminate many more “emotional” choices. I also like strategies such as the one that I call “Fallen Angels.” This is a system of searching key industries or sectors that are poised for long-term growth. If some unusual event occurs (perhaps a tsunami), that pushes your pick down for non-fundamental reasons, it provides you with a buying opportunity.

It is also helpful to note that far too often, people have a plan but in the face of emotions, they fail to execute. When investors have the opportunities that they were looking for, they let fear overtake their rational sides and don’t make the planned purchases. It’s hard to buy into the market when it’s heading down, but that’s often when the best deals are to be had.

Finally, my experience has been that most of us are much more apt to react to external circumstances, although that tends to be far less productive than planning ahead. Think ahead about what your triggers will be for purchases. Prices? Particular days? What are your tax and estate vulnerabilities? What is your plan to remediate these vulnerabilities?

Two Examples

Swine Flu

Toward the latter part of 2008, Swine Flu (H1N1) dominated the headlines. Fear mongers warned of the risks of eating pork. Mad Cow disease, a few years before, was a similar story. Fast forwarding to today is a completely different story—roughly two years after the major market sell-off, pork, beef, and poultry producers (not retailers) have been among the biggest winners in the current bull market.

Oil

After the 2001 recession, a barrel of oil cost about \$30. Within a few years, the same barrel was trading for over \$140. Some analysts even suggested that the price could reach as high as \$200. In spite of this, research showed that output for oil was actually rising, in some instances, faster than consumption, which would have implied a price drop, rather than an increase. The fear trade was to buy oil and to sell transports (that would have had compressed margins due to high fuel costs). That trade wouldn't have worked out very well. Economics 101 suggests when a price becomes too high, consumers find less expensive alternatives or just do without (known as "demand destruction"). High prices did eventually create a drop in demand—which brought oil prices down with it.

Today, energy is again on a tear with Middle East fears front and center. Is the current higher price for oil (in the \$100 range) warranted? Perhaps, but a funny thing has happened over the last few weeks, as reports have suggested that oil consumption has been dropping. Maybe the fear trade should, again, be a contrarian one - if you have profits in the energy sector,

it may be time to take those profits off the table and to reinvest the proceeds into spaces that have suffered from these higher oil prices. Consider taking positions in transports that dropped on higher oil but are not as adversely affected by higher energy prices as their competitors.

Although it is a tough comparison, let me remind you that when the oil spill occurred in the Gulf of Mexico, the prices of oil-related shares were seriously pressured. One theme that seemed to keep dominating the news was nuclear energy. After the recent devastation in Japan and the ensuing nuclear issues, the tide has quickly turned back.

KEN'S FIVE INVESTING RULES

1) Plan for the Unexpected

How can one plan for the unexpected? The answer is to create the game plan and to already be positioned to execute based on what transpires. Think of the show *The Iron Chef*, in which each chef has already created a plan by formulating various recipes. Depending on which ingredient they are tasked with using, they will invoke their strategy and call upon the proper recipe to execute the task. We don't know if oil will go higher, but we can plan on it by investing in strong companies having strong growth opportunities, regardless of oil prices. If oil does go higher, it can make the investment that much stronger. If oil goes lower, which companies stand to be affected the most and the least?

Additionally, plan for other parts of your Legacy. We talk about wealth, asset protection, even taxes. But far too often we neglect other parts of our

legacy. What happens if you get sick? Who knows where your key documents are located? Where do you keep your jewelry and what do you own? What are your medical allergies and issues? Who should we call if you die? Have you written your Family Love Letters, completed your 5 Wishes Workbook, or even completed a Letter of Instruction? Even if the process takes a few hours, it's important to host a family meeting and distribute these important documents to those that you rely on.

2) Rotate and Execute

When something is going well or poorly, it is easy to become complacent with your plan. This tendency often allows us to let our winners run just a bit too long and for us to not cut our losers soon enough.

The one constant is change. There will be times that your strategy tells you that it is time to buy or sell a holding and I advocate executing, rather than just hemming and hawing about it. When your plan says you will have a certain percentage of a specific sector or region, do not alter your course because of a headline. Japan may face terrible headlines today, but those headlines might have a silver lining later on.

US stocks climbed a seemingly insurmountable wall of debt, worry, and recession to a powerful two year bull market from the lows of March 2009. The margin of error continues to narrow. Fundamentals suggest to me an almost equal weight of downside loss versus upside potential. If your plan calls for a rotation, try to put your emotions to the side and make the rotations that your plan calls for.

3) Find Opportunity in Adversity

This concept has been stated in so many different ways, but the essence is that emotions usually cause people to do the wrong thing at the wrong time. Do you remember the market reaction to the terrorist attacks of 9/11? Uncertainty created panic, which created opportunity for those brave enough to step in. Unfortunately, times of human adversity often present opportunities to build upon macro trends and to add to Fallen Angels. Keep cash on hand for when these opportunities arise.

4) Look for Macro Trends

If you look around, you see it happening right around you: 5,000+ people per day reach 65 years of age. What goods, services and activities will this huge group seek? Will pharmaceuticals do well? How about senior-housing communities?

As Third World nations evolve, what goods and services will they require? What will population growth do to demand for food, housing and other staples?

The Macro Trends in Technology are even more astounding. Chips have become smaller and more powerful. We can now talk and watch TV on the Internet and we can get access to the Internet on our, now ubiquitous, smartphones. Yes, that's right, we're using our phones to access the Internet to make phone calls! Five years ago, no one even knew about tablet computers, which now sell millions of units annually. As we speak, companies are replacing their hardware by "going to the cloud."

Following Macro Trends is about watching how the world around you is developing and targeting a portion

of your strategy to areas in which you see demand growing. The way that we live is always changing, which creates an unending opportunity for investment.

5) Plan for Contingencies

Once your plan is in place, it's almost a certainty that the event that you expect to happen least will happen. As part of your plan, be sure to hold assets that can zig when the market zags. Once this has been accomplished, be sure that you have the discipline and strategy to hold on when times look bleak for these investments and they are underperforming. "Black Swan" events will always happen and that is when your Uncorrelated investments begin to shine. Look at investments in bonds (particularly Treasury inflation protected bonds), overseas assets, commodities or real estate as potential ways to hedge your risk. There are also a growing number of products that seek to hedge volatility by using Market Neutral or Long / Short strategies that you could consider.

MY 5 BIGGEST FEARS

As time marches forward, old fears are replaced by new ones. We will never be able to predict the next big crisis, but we can plan for many possibilities. To plan appropriately, we have to ponder the "what-ifs" and, as of now, the following five dominate my list of top fears:

1) The Middle East

What do you get when you combine a geographic area, known for inhabitants with extremist views, monarchies / dictatorships and young people seeking more, all sitting on a valuable global commodity? The answer is the

tinder box known as the Middle East. In addition to the changing political landscape there, add in the Israeli conflict, nuclear issues, terrorism and the causes for concern are high.

2) The Rally has left no Margin for Error

When markets are cheap, there is often a clear cause, such as a recession that pushes stock prices down. When stocks get low enough to price in that economic weakness, we reach a point at which the upside arguably outweighs the downside. However, when stocks rise faster than the growth rate, the way to justify higher prices is to speculate on future growth. If the expected growth doesn't materialize, the potential for downside risk could become greater than the potential for upside reward.

3) Debt

Greece and Spain are back in the news with ongoing debt woes. Ireland has been forced to take bailouts. In my opinion, the way the United States has printed money and increased our debt is going to be a serious issue to deal with. Many states are also awash in debt which could hamper further growth. It's a question of "when," not "if" these become bigger problems.

4) Stagflation

The only thing worse than inflation is high inflation during a soft economy or recession. The term for this is stagflation. Many commodity prices have become exceedingly high. Sooner or later, this additional cost will have to filter down to the consumer to the consumer level. If the economy does not recover in a meaningful way, high inflation during a slowdown points towards a 1970's scenario, all over again.

5) The Big, Bad Ugly

I have always stated that you can plan for health care issues, market corrections, inflation and many other events. But you can't plan to have your heart attack on a convenient Tuesday afternoon. It is only prudent to be concerned about what you don't know.

SUMMARY

It's been said that the right trade is sometimes no trade at all, which is a hard thing to do for those of us that are hard-wired to trade. Other times the hardest trade is to stick to your strategy and buy through adversity. Often, the worst trade is to panic and sell at the wrong time. There is no doubt that the world around us will continue to change and that our plans and hopes, personal and financial, will have to evolve and adapt. There will always be plenty to worry about. If you want to add Alpha to your portfolio and to your life, my advice is to stay disciplined and to allow financial E.S.P. into your life.

Disclosures:

Municipal Bonds and TIPS investments may not be suitable for all investors. Investing in municipal bonds involves risks including, but not limited to, interest rate risk, credit risk, market risk, inflation and high-yield risk, and possible loss of principal. Interest on out of state bonds and dividends paid are subject to state and local taxes. Income may also be subject to the Alternative Minimum Tax.

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Commodities trading is not suitable for all investors as an investor may lose all or some of the original investments. The risk of loss in trading futures can be substantial. Before trading, investors should read the "Risk Disclosure Statement" and should understand the risks in light of their own financial situation. Along with potential for profits there is the potential for losses which may be very large.

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