The CJ Investment Newsletter

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July, 2011 *One Hundred Sixty Third Issue*

Herding Behavior in Investing

Purpose

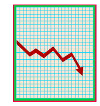
The *CJ* Investment Newsletter deals with the entire spectrum of securities investing, including cash (money market funds), bonds, equities and options. It will evaluate the overall investing environment and then discuss the relative allocations of these asset types, as well as strategies to implement within them. Essentially, it reflects what I'm actually doing with my clients.

These letters are not sent "cold." Either I know you or someone you know gave me your name. Yes, this letter *is* a sales tool. It communicates how I apply my investment strategies, so that you can decide, without any sales pressure, if my thinking is compatible with how you want your money invested. If you're not already a client, I would like to discuss your *becoming* a client. Please call me for more information.

However, that's not its only purpose. Even if you never become a client, if you want this information, I want you to have it – for a while, anyway. My hope is that providing this information and teaching you what I think is important when investing may help you. Please contact me if you have any questions or comments. I'd love to hear your reaction to my letter.

The CJ Growth Strategy (back page) has been an ongoing aggressive growth model portfolio since 1/98. Its results continue to be tracked herein.

Quick Look

Market	**Next Expected Move**
?	

- Robert Prechter attacks exogenous-cause logic and herd behavior. His points are radical and well worth considering.
- QE2 isn't "over."
- Some characteristics of market moves.
- The TCM website has real content now!

Errors from Fundamental Thinking

I love reading brilliant people. In the March 2011 edition of his *Elliott Wave Theorist*, Robert Prechter discusses and criticizes exogenous-cause thinking. Such traditional thinking states that effects have exogenous (external) causes. Applied to markets and economics, it overlaps heavily with "fundamental" (financial metric-based) causality. Here's a very short snippet from that article, entitled "The Awesome Power of Consensus Thinking:"

"Shining a light on contradictions between belief and reality…makes one realize how powerfully humans must be impelled unconsciously to use exogenous-cause logic in a social setting. Not even the most blatant contrary evidence can shake it. If you wonder why more people do not adopt socionomic thinking, here it is: Fundamentalist thinking feels right even

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*"The best weapon the amateur investor possesses to protect himself from stupid or ill-conceived action is **technical analysis**."* - Richard Russell, *Dow Theory Letters* #1494
Actually, I think this is true for ALL investors. - Callom

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though it's wrong, and socionomic causality feels wrong even though it's right.

"Fundamentalist logic always makes sense. But it usually contradicts important evidence. And it has no useful application. Yet in economics it is the coin of the realm. With it, you can buy your way into any financial discussion, and you can be assured respect as well. The only thing you can't do is help anybody."

Amazing. And brave, too. Not many, even those as rich, successful and respected as Prechter, have the courage to criticize the "conventional wisdom" because of the price he/she could pay. Galileo Galilei comes to mind. Socrates, too.

In addition to discussing and supporting his arguments regarding the fallacy of believing in exogenous-cause logic, Prechter makes the additional case of how this almost universally believed (and flawed) way of thinking becomes even harder to argue against when the natural herding traits of human beings also become engaged. That is, at market extremes, when the market is actually getting ready to reverse and head in the other direction.

Coincidentally, Richard Russell recently wrote in his *Dow Theory Letters* # 1494: "In this business, your **worst enemy** is your emotions. It's ironic and only human to feel most confident (glee) just before the market hits a peak. Conversely, it's human nature to feel most disgusted (yuck) just as the market hits a bottom… Which is why it's been said that the most frustrating mechanism ever created by man is the stock market."

Prechter humorously relates that, often times, people will listen to him speak about these phenomena, agree that he supports his case well and even agree that what he describes is true, *but he can't be right this time* because of some "fundamental" argument. Talk about proving his case!

This particular idea is conceptually consistent with the basis of "contrarian" investing, although I've never read anyone describe the phenomenon as completely and support the case as well as Prechter did. Actually, compared to Prechter's thinking here, most contrarian theory (and practice) has more to do with simply being "disagreeable" or "rebellious" than a carefully applied discipline in which you look for real indications of herd behavior indicating a trend is about to reverse, then act in a fashion to either get ahead of it catch it when it changes.

I, myself, have used charting techniques over the years in order to attempt to pick contrarian entry and exit points. The *CJC Indicator* was constructed, among other things, to point out such "Holy Grail" points. I'd love to talk to Prechter to see what he uses to detect market turning points.

Personally, I've always had problems with relationships presented as cause/effect, especially in investing and economics, when the effect does not *always* follow the cause. Logically, then, there simply *can't* be a causal relationship. And don't get me started on "statistical correlations." Prechter is criticizing the continued belief in causation that simply isn't supported by the evidence. Smart people don't hold on to incorrect thinking, especially when it can consistently cost them money. Yet, it happens all the time.

I will add that I don't believe Austrian Economics falls in the purview of what Prechter is criticizing. Properly applied, Austrian thinking seems very real-world and predictive to me. I've personally found that if my predicted effects didn't materialize, I was generally applying the theory inappropriately. Additionally, as anomalies or differences appear to me between predicted and actual results, I have tried (within the limits of my talent) to improve my understanding or, even, modify the theory or its application such that it works better for me in the future.

I don't believe either Keynesian and post-Keynesian thinking is either real-world or predictive. It can be applied perfectly and is still usually wrong. Look at how its applications since the 1930's have damaged the economies of the world. Like Prechter said: "Not even the most blatant contrary evidence can shake it."

Even if you disagree with Prechter, they are interesting and important points to ponder. And, you have to admire a guy who has the brains, respect, bravery and confidence to challenge darned near the combined "conventional wisdom" of both investing and economics at once!

QE2 Isn't Over

There has been a lot of hoopla recently regarding the "ending" of the Fed's second quantitative easing program, dubbed "QE2" by most for brevity's sake. I have a really hard time deciding whether to go into "conspiracy" mode for the explanation of this or to believe that the folks presenting this to the rest of us are simply ignorant or unaware of what they're saying.

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The "rub" is this: If QE2 is going away, the Fed would have to *remove* the additional $600 billion (?) from M0 it added throughout the time QE2 was supposed to be in effect. The Fed is not going to do that. In fact, Bernanke and, I believe, some other Fed governors have come out and said the Fed will "maintain the Fed's balance sheet at the current level." This means that *as the debt the Fed purchased from corresponding banks is retired by the debtors, the Fed will purchase additional debt to maintain M0 at or around its current level.*

It may seem like a "small" matter – "just" $600 billion at the M0 level and *5 times that much for M3* at current multiplier levels – but leaving the entire monetary stimulus in place does not constitute "ending" the monetary stimulus. *Removing it does*. This is an important difference, and giving the public the message that QE2 is ending is a misrepresentation of the facts – intentional or unintentional. Additionally, the Fed has been noncommittal at best regarding any future plans they may have for eventually reducing its balance sheet and actually removing any of the monetary stimulus. What's wrong with just telling the truth?

Some Current Market Observations

Beginning at the intraday high of 12876 on 5/2/2011 and for the next six weeks or so, the DJI lost roughly 1000 points (about 7.75%). It looks like today the DJI will finish at almost 12400 – almost a 500-point rally in four days – all occurring this week.

One market characteristic I've written about relatively often in the past is the movement characteristics of the market. The market will generally make steady, if not spectacular, progress towards its eventual primary zenith (bull) or nadir (bear). Corrections (or secondary reactions) of these moves are generally much faster and more violent. Once corrections are done, slower, steady movement in the primary direction begins again. This is not a "rule," but markets tend to play out this way much more often than not.

Additionally, corrections generally retrace between 1/3 to 2/3 of the previous move before the market begins to again move in the primary direction. The "average" correction is about 50% of the extent of the previous primary move.

Richard Russell, probably the greatest Dow Theorist of all time, regularly describes both of the above characteristics. Since first learning this years ago from him, I have to agree my experience supports this thesis.

By this standard, this rally is weak and is probably not sustainable. About 50% of a six-week decline being retraced in four days definitely qualifies as a correction in my mind.

After the discussion above regarding Prechter's feelings on "fundamental" data, I won't deal with those metrics here. I'm not even sure he feels that *all* "fundamental" measures of value are incorrect or misleading. Still, I'm not sure I've ever seen him write about which measures, if any, *do* have merit, at least in their traditional application.

Trend Capital's Website

Since last month's newsletter, I've managed to add significantly to the content of Trend's website (www.trendcapitalmgmt.com), including links to my three interviews with Stuart Varney on Fox Business Network in 2008 – 2009. I realize that was a while ago, but much of the content of those interviews is applicable today. Besides, even though I haven't appeared on international cable TV for a couple of years, I'm still proud of having been on there at all. I might have been on more, but my contact with Varney's show changed jobs and I never heard from her replacement. *C'est la vie*.

In addition to the three FBN interviews, links to 13 of my 14 published articles are there, as well as over 30 of my newsletters – cleared of references to my previous firm and other legally problematic content. Don't you just love living in a legalistic and litigious society?

The most recent *CJ Newsletter* and published print article (*KC Star*, 5/17/2011) are linked on the home page, with internal links back to the archive pages where older content can be accessed.

I have no intention of putting *all* of my old *CJ Newsletters* up on the site – just the ones that have "meaningful" content. Such content would include theory, explanations and other information that has some relevance to today or will help you understand current market and economic conditions better. If an older letter only has *some* meaningful content, only that portion of it will be presented on the site.

Please check out TCM's website and provide me with some feedback or suggestions. Thanks for your interest!