



MANCHESTER

CAPITAL MANAGEMENT, LLC

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Strong Year-End Finish Despite Slowing Economy!

As we come to the end of the year, our portfolio performance remains strong in the face of a worrisome outlook on earnings, the economy, inflation, and changes in the financial markets.

I doubt we will have a recession, although there is plenty of evidence that both the U.S. and global economies are slowing faster than we expected. Housing is in the worst state in many decades: fewer sales, too much inventory, and declining prices. U.S. carmakers are struggling, and now have less than 50% domestic market share. The large U.S. pharmaceutical companies have a weak pipeline of new drugs and are losing cash flows to generic drugs.

About one-third of the S&P earnings are delivered by the financial sector, which includes the banks and mortgage lenders who have been hit hard by the losses in the credit markets that they manage. They could report no earnings at all.

After five years of strong profits, productivity, and employment, we shouldn't be surprised to revert to the mean and to suffer some negative numbers. While we might not get hit with an economic recession, often defined as two consecutive quarters of negative GDP growth, we are certainly in an earnings recession!

It is uncertain how long the current slowdown will last. Politicians are proposing plans to help homeowners by putting a freeze on interest rate hikes on adjustable rate mortgages. The Federal Reserve is slowly lowering short-term interest rates to spur economic activity. There is a new, global coordination of central banks to introduce liquidity into the international credit markets.

Liquidity helps, but the real problem remains uncertainty about the value of the underlying assets. How much is that home really worth, even if the politicians make it cheaper to pay the mortgage? How much are banks helped when the cost of their short-term borrowing is cheaper if they still don't know what they really own?

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Meanwhile, the markets continue to be whipsawed. Two or three percent moves in the markets are becoming common, and we have had two separate ten-percent corrections since the summer. I have confidence that the current slowdown will be short-lived, as supply and demand will eventually reestablish the correct equilibrium between credit and true value. I do worry, however, that there are changes in the financial markets which are less noticed, but more damaging.

Healthy markets require transparency. Investors need to know what they are buying. For example, when you buy shares in IBM you deserve a clear and full description of the liabilities and assets. I fear that our markets are becoming more and more opaque, as financial wizards create off-balance sheet transactions and third-party liabilities that disguise rather than disclose the financial well-being of assets.

Every generation promises that they know what they're doing, such as in 1987 with portfolio insurance, or 2001 with Enron, or in 2007 with sub-primes and CDOs, we pay the price for their hubris. And they usually make a bundle. Big firms are selling their clients complex, illiquid products to garner fees at the same time that they are shorting them. The accounting industry has had to invent something called "Level 3" assets to denote "assets" so mysterious they can't be valued by any conventional test. You know you are being had at the poker table when the sales pitch involves the three magic terms: illiquidity, complexity, and risk control.

Healthy markets also require price freedom. Willing buyers must be able to negotiate with willing sellers to independently establish price. The polls show a new willingness to create protectionist trade barriers between countries, imposing restrictions on buyers and sellers that always end up hurting both groups. The current distress in the credit markets is prompting politicians from both parties to try to set price controls on the interest rate charges for mortgages or to create artificial buyers for illiquid credit securities. History has shown the problems that arise when government committees set prices rather than individual consumers. Educated consumers and informed investors are the best weapon against the abuse of whiz kids and corporate misrepresentations.

Next year will be tricky, nerve racking, surprising, and in the end, profitable if we seek to understand the underlying changes, focus on the real threats, and take advantage of the opportunities.

Ted Cronin, CIO



Behavioral Finance and Investment Decisions

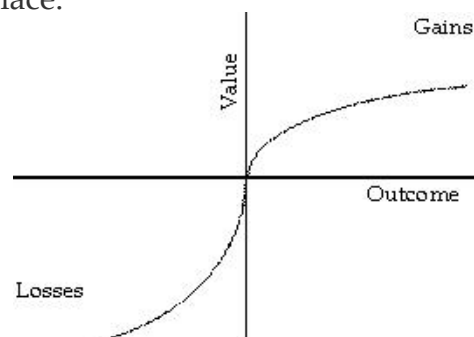
By Morgan Roberts, Senior Investment Manager

A bat and ball cost a dollar and ten cents. The bat costs a dollar more than the ball, how much is the ball? The answer is easy, right? The ball costs ten cents. Our response to this question is a simple example of a more profound force influencing the financial markets – behavioral finance. As humans we respond to many financial situations with instinctive behavioral tendencies. And, as you will find out, our behavior is fairly predictable and may help explain many of the price abnormalities we see in the marketplace. The purpose of this article is to identify some of the behavioral pitfalls exhibited by individuals and thereby help you avoid them. Oh, the ball actually costs five cents.

The Efficient Market Hypothesis, the foundation of Modern Portfolio Theory, assumes that the market is efficient because market prices reflect all publicly available information and investors are rational. More and more economists are advancing the notion that the market may not be perfectly efficient because individual investors appear to be driven more by behavioral biases than rational models. Over the last decade, these behavioral economists have made some remarkable discoveries on how humans perceive rewards, evaluate risks, and calculate probabilities.

One example of behavioral bias is that individual investors generally find it easier to sell winning stocks than losers. Individual investors have a hard time selling a stock that has gone down because they seem to be unwilling to accept the loss, hoping that the stock will eventually turn around. Behavioral scientists explain that individuals become “anchored” to a particular price, usually the purchase price, rather than rationally reevaluating the stock to determine whether or not they should sell. This behavioral bias applies to buying decisions as well. When I was in the Dominican Republic I was fascinated with the selling techniques of the local vendors. I asked one jewelry salesman how much a necklace cost. He said \$75. When I said it was too much, he said he would give it to me for \$50. When I said it was still too much, he said he could sell it to me for \$35. I thought about it and offered him \$30. He said yes. In retrospect, the vendor probably would have sold me the necklace for \$5, but by stating the initial price of \$75 he was able to set a high reference point and get a higher sale price. I was framing my decision on the difference between \$75 and \$30 not on the real, or rational, cost of the necklace.

As you can see from the following graph, as investment gains increase, the individual's satisfaction increases at a declining rate. For example, a gain of \$10,000 feels better than the initial gain of \$5,000, but not twice as good. Similarly, a loss of \$10,000 feels worse than the initial loss of \$5,000, but not twice as bad. Notice the key point that the loss side is steeper than the gain side, meaning there is a greater adverse reaction to losses than perceived satisfaction for gains. This behavioral bias creates price dislocations in the market. For instance,



The Kahneman-Tversky value function representing an individual's preferences over gains and losses measured relative to some reference point. The figure shows that the individual is risk-averse in gains, risk-seeking in losses, with losses looming larger than gains.



poorly performing stocks may still be overpriced because those who should be selling, if they were rational, have yet to sell because of their behavioral reluctance.

Another example of behavioral bias is momentum investing (trading). Why are individuals compelled to buy stocks when the market is doing well and sell when the market is doing poorly? Psychologists explain this behavioral phenomenon as 'herding.' As the market increases, individuals feel they are missing out and tend to gravitate into the market with no regard to risk. A study by Daniel, Hirshleifer, & Subrahmanyam (1998) shows that individuals generally don't act on a decision until they have confirming information (i.e., to buy when a stock has gone up). Another example of this phenomenon is betting on a craps table at a casino. While each roll is entirely independent, individuals tend to bet more during 'hot rolls' than during 'cold rolls.' There is no rational explanation for this phenomenon other than behavioral biases.

Individual investors can avoid momentum investing by limiting trades. Despite the huge increase in day-trading, there is no evidence that prolific trading adds value. In fact, studies show that trading routinely detracts value. A study by Barber, Odean and Zhu (2005) discovered that the stocks most heavily purchased by individual investors underperformed the most heavily sold by 4.4% over a one-year period. As a result, the individuals who traded the most ended up with the lowest average annual returns, while those who traded the least ended up with the highest average returns.

At Manchester Capital, we understand there are patterns of behavior that affect the markets. We strive to incorporate these findings into our investment process and portfolio management. Our clients have already done the most important thing to protect themselves from behavioral biases; they have hired a third-party to manage their investments.

*Sources: Thaler, Richard, *Advances in Behavioral Finance*, Princeton University Press, Princeton, N.J. 2005
Wells Fargo, *The Behavioral Finance Paradigm*, 2007 Wells Fargo Funds Management, LLC,
Jason Zweig, *Your Money and Your Brain*, Simon & Schuster, New York, 2007*

Our Best Wishes For A Happy and Healthy Holiday Season! ***Inside MCM***

We are Pleased to Welcome Bart Earley to MCM!



Bart joined our Manchester Office in May 2007 where he is responsible for maintaining the firm's platform of investment managers and leading our ongoing research for new managers. He also serves on the Manchester Capital Investment Committee and is active in the firm's financial planning efforts. Prior to joining Manchester Capital, Bart worked for an independent financial planning firm in Albany, New York and was Vice President of Wainwright Investment Counsel, LLC, an independent investment consulting firm in Boston. He received his BS in Finance, with a concentration in accounting, from Siena College and has earned both the Chartered Financial Analyst and Certified Financial Planner designation. He is a member of the CFA Institute and Financial Planning Association.