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PAST RESULTS ARE NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

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-- BEHAVIORAL FINANCE --

1st Quarter 2004

Do you remember your New Year's resolutions? Studies have shown that most New Year's resolutions aren't followed through to completion. If they were, the diet industry would be out of business. It has been over 3 months since New Years Eve, and I have been reflecting on the resolutions that I made at the end of last year. My wife and I, along with our 4 year old daughter, spent New Years Eve on the coast of California about 30 miles north of Santa Barbara, at our second home. It is there, in the beautiful solitude of the "Sundt Ranch" as I call it, where I do my best thinking and reflecting on the years gone by and the years coming up. Each year we try to focus our goals on 6 areas: spiritual; mental; family and friends; physical; financial and career. Without getting too personal, I will tell you that this year I made "improving financial decision making" one of my goals. Studies have shown that one of the more common resolutions is to "make more money."

"A moment's insight is sometimes worth a life's experience."
Oliver Wendell Holmes (physician and writer) 1800's

I think a more sober and rational resolution for many people is to ***invest smarter***. By this I mean resolve to be a more *intelligent investor*—resolve to make *better investment decisions*. If you're a physician who made $250,000 last year, it may be difficult to increase your patient workload and double your professional income to $500,000 this year. If you run a widget business, it may be unreasonable to double your sales volume in 12 months. But it is possible to take your $1.5 million portfolio, change the allocation and dramatically increase or decrease your potential investment income (and net worth) over the next 12 months. Just imagine what a difference an allocation to bonds versus stocks would have produced over the last 5 years. If this is true, than becoming a more intelligent investor should replace our goal of "making more money" in 2004. But how much time do we really spend analyzing our decision making process? It is truly amazing to me how little time some people spend on making investment decisions as opposed to say, exercising or deciding on where to vacation. Yet, investing smarter can have a dramatic impact on how much time you have to spend exercising or vacationing!

This begs the question: "How do you or I become a more intelligent investor?"

At Altegris, we take that question seriously. That is why I'm writing this newsletter—to share my own thoughts about *risk and return* and to develop a deeper, clearer and more complex understanding about the process of making investment decisions. This takes time, practice and years to develop. I hope that the dialogue that began with my 4th quarter 2003 letter, "Smoke and Fire," was only the beginning of a deeper examination of investment issues and choices over the course of the year 2004.

In my first letter I drew upon the expertise of some very bright strategic thinkers. I talked about my meetings with Marc Faber, Richard Russell and Jim Rogers, and I explained what some of their current world views

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were at that time. I call these men “macro thinkers.” They tend to look at the entire world as their investing landscape, rather just the U.S. Instead of deciding if Dell or IBM are better bets, these gentlemen may compel you to ask if the U.S. versus Europe is a better bet, or the dollar versus Yen, or Energy and Commodities versus Equities. This is important in the investing world. I like to use the following comparison: Rather than ask what the best item on the menu is, ask if you are in the right restaurant!

Researching global opportunities is only part of the solution to becoming a smarter investor. You and I can talk about geo-political scenarios, and various economic outcomes. We can discuss various hedge fund strategies that may be able to take advantage of these scenarios or outcomes. I love to explore these questions. But none of this matters if our fundamental decision making process surrounding how we invest is flawed. You and I must evaluate our internal investment decisions: the how and why we invest—before we can trust our external decisions: the where to invest. For the sportsmen out there, I will use this analogy: “Can you have a good 18 hole golf game while you are in an argument with your spouse or stressed out about work?” You first have to calm the inner game before you can master the external game. In my last newsletter, I stated that our brains are better wired for short term decision making than for long term strategic planning. This has a profound effect on how we invest.

> ***“Few people think more than two or three times a year;***
> ***I have made an international reputation for myself***
> ***by thinking once or twice a week.”***
> George Bernard Shaw

I believe one of the best ways to make better investment decisions is to start first with a good understanding of ***behavioral finance***. This field was validated at the highest level when the 2002 Nobel Prize in Economics was awarded to one of the pioneers of behavioral economics, Daniel Kahneman.

Most of you have heard the argument that the markets are “efficient.” The PhD’s that invented this notion, based it on the assumption that individuals act rationally and consider all available information in the decision making process. Anyone that has been a trader of money in the capital markets would argue that the markets are irrational and the efficient market theory was wrong. In the last decade, however, researchers have been able to pinpoint one of the reasons why the markets do not act rationally. It all hinges on the way our brains are wired and how we respond to market information, both individually and en masse. Dozens of examples of irrational behavior linked to repeated bubbles and bursts have been documented in academic studies and headline news. As I said in my earlier newsletter, “Our brains are hardwired in such a way that we may have a distinct *disadvantage* in making intelligent investment decisions.”

This is a complex subject, and I am currently reading my third book regarding behavioral finance, but let me give you three powerful examples of what the research is telling us about how we are wired. I believe if you and I can internalize these concepts it will have a profound effect on our investments over the next decade. I will give them nicknames to help you remember: Smoke, Anchoring and Regret.

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SMOKE

When people are in doubt, they tend to look to others to confirm their behavior. Some people would rather adopt other's opinions rather than form their own. Two scientists named Latane and Darley performed one of the most amazing experiments that demonstrate this. They asked people to sit in a room and fill out a questionnaire, under the guise of research. They then leaked smoke into the room through a vent to see how long it would take people to leave the room. It turns out that the people who were alone, left more quickly, which seems like the obvious, reasonable thing to do. The scientists then did the experiment on groups of people in the room. They found that it takes far longer for people to leave if there are others in the room. People like to follow the lead of others, and since everyone was busy filling out the form, they thought it must be O.K. to sit in a room filling up with smoke! Everyone was waiting for someone to stand up and yell "Fire!" Do you see the relevance to investing? It is profound.

ANCHORING

Imagine you are at a car auction hoping to by a beautiful red '66 Corvette. Imagine the car that is being auctioned before the Corvette is a 1955 Mercedes Gull Wing Coupe that sells for $750,000. The Corvette is up next and the Blue Book price is $35,000. What would you bid? Now imagine the car before yours was a "kit" car replica of the Gull Wing Mercedes that sold for $75,000. What would you pay now? Research has shown that incidental price data can effect what you are willing to pay. We have a tendency to pay more if the preceding price is considerably higher!

Let me put it another way: People tend to give more credibility to recent experience and project that experience into the future. We become more optimistic about our portfolios when the value is rising, and more pessimistic when values are falling. We tend to "anchor" ourselves to recent data. Investors tend to buy "hot " funds that had a good last year, as opposed to looking at longer-term averages. Last year the S&P 500 Index was up 26.39%*. As an example, some investors might anchor themselves to that number, and ignore investments that were up 5% last year, even if those investments averaged 12% over the last 4 years. I saw this kind of behavior often in the year 1999.

REGRET

People try to avoid actions that confirm they have made a mistake. We try to avoid regret. My wife can give you plenty examples of this in my day to day life. A classic example is a study that showed that new car buyers selectively avoided ads for models they did not choose, and instead, were attracted to ads of the car they had recently purchased. In the investing world, we may buy a stock that declines dramatically in value. Rather than sell it and admit a loss, we tend to hold onto the investment until it reaches "the old buy price" before we sell. Thus, we can avoid saying we were wrong!

*Source - S&P 500: S&P 500 Index.
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So how can we avoid these three common mistakes? Awareness is the first step. Try developing a mental checklist that you must go through before pulling the trigger on any investment. Learn to be objective. To counter act the "smoke effect," learn to challenge the norms. To avoid the "anchoring effect," learn to look past the last year's performance. For the "fear of regret," read and consider other points of view. Disassociate yourself from your emotions.

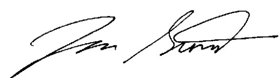
My late father was a very successful real estate developer here in San Diego. A Princeton graduate and an ex-Navy Seal, he understood a few things about investing and people. He used to say to me, "Jon, don't get attached to a piece of property, because then it will own you. If you become emotionally attached to an investment, you're no longer a rational investor."

As founder and president of Altegris, I get paid to help investors. These are the ideas and questions that my team and I constantly wrestle with and ask ourselves. I believe that awareness of behavioral economics is helpful to our process. I don't ever want to become emotionally attached to a money manager or to recommend a money manager simply because he or she made money over the last 12 months.

When you reflect on these concepts, ask yourself some tough questions: Where were you in the summer of 2000? What did your portfolio look like? What were you feeling? Did you smell the smoke? Did you become emotionally attached? As the market was cracking, did you have *fear of regret*?

Long before behavioral economics was legit, my father used to say ***"Don't confuse the dream with reality."***

Until next time,



Jon C. Sundt
President

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