

INSIGHTS ON FRONT STREET



BY JOHN W. GUDRITZ, CFA

FEAR CAN BE YOUR FRIEND

SEPTEMBER 2007

There is an old adage on Wall Street that says the stock market is driven by two emotions: fear and greed. As Gordon Gekko in Oliver Stone's movie *Wall Street* learned, greed is not good and can be an investor's fatal flaw. Greed changes rational thought and analysis into irrational hopes and dreams of getting rich quick. It will usually end up destroying wealth. At the other extreme end of fluctuating investor sentiment is *fear*, which we are seeing in the real estate market and some stock prices today. Fear tends to paralyze or panic investors as prices tumble. However, it also sets up great buying opportunities for those of us who look at fear in the market as our friend.

I first got into the investment business in June of 1982, near the end of a long and treacherous bear market. Fear was everywhere on Wall Street and Main Street. The economy was in a recession and interest rates were going up in an effort to choke off inflation. No one had made money in the stock market in ten years except for some adept traders. Many people questioned my sanity for this career choice.

Being a rookie and not yet emotionally scarred from bear market experiences, all I saw when I looked at the market that summer were a lot of very cheap stocks. I was like a kid in the candy store wanting to buy all kinds of beaten down stocks. I did not understand why the older, more experienced people in the profession were expressing caution.

So I learned early in my career that the emotion of fear in a market brings opportunities for big gains. The challenging part is overcoming the anxiety of increasing exposure to an asset class that is in the midst of a meltdown to take advantage of the tremendous buying opportunities.

It wasn't until the summer of 1987 that I witnessed investor greed for the first time. The stock market was up 40% by August and prices were high. I remember investment managers who were selling into this rally being ridiculed for being market timers and not long-term investors.

The "Crash of 1987" in October taught me the consequences of greed when the Dow Jones Industrial Average fell over 20% in one day! Talk about volatility. I had older

clients who remembered that Crash of 1929 calling me to make sure I wasn't out on the ledge ready to jump. Actually, I was busy putting together a list of stocks I was going to buy.

The most extreme example of greed I have ever seen was the technology stock bubble in 1999. People were buying any stock that had "dot com" attached to its name even when the "company" consisted of only inexperienced college students with a few computers. It was an insane time to be a sane investor and that kept me out of those stocks.

While the bursting of that bubble did some serious financial damage to most portfolios, the ensuing fear in the market set the stage for another wonderful investing opportunity in 2003 with a new bull market that is now struggling but still alive today.

Over the last year we were concerned that investors were getting a little greedy again, chasing take-over candidates and loading up on complicated debt securities that few people understood. There was little regard for risk despite falling home prices and rising default rates on mortgages that we thought would have a detrimental effect on the economy. In the end our worries have proven to be correct and the extent of the damage to the economy is still playing out.

Anyone paying attention to the stock market over the last few weeks may have felt twinges of fear on those days when the market seem to be in a freefall. We have not seen so many days of 1% to 3% market declines since 2002. The good news is that the market has been finding reasons to bounce right back, helping to relieve investors of some of their anxieties but keeping them on edge nevertheless.

This significant rise in market volatility since July has caused many individual investors to reduce their exposure to the U.S. stock market. Recent surveys show that investors have pulled more than \$13 billion from domestic mutual funds over the last two months. Most of that money is hiding out in money market funds. Fear is obviously playing a role in that decision.

Wall Street strategists are currently warning investors to stay away from all financial and housing related stocks because of the spreading sub-prime mortgage disease. With such negative sentiment we cannot resist the temptation to look around for investment ideas and we have added to that sector in the portfolios.

The markets will continue to be driven by fear and greed as long as human beings are making the investment decisions. We are just programmed that way. At the moment fear has the upper hand in investor sentiment as every day we hear more bad news about the housing and mortgage markets. "Will there be a recession?" is the question everyone is asking.

We are comfortable using this fear and volatility in the market to find cheap stocks because the Federal Reserve has demonstrated in word and deed that they stand ready to cut short-term interest rates to keep the economy growing. We think the lower interest rates will keep investors focused on the possibilities of the future instead of the problems of the past.

 **Phone: (231) 947-3775**
Front Street Investment Management
400 W. Front Street Suite 206
Traverse City, Michigan 49684