

Why we lose . . .

You know at first glance it doesn't seem that difficult to beat the stock market. *Take a look at the chart at the bottom.* Between 1995 and 2000, the technology sector grew dramatically as a percentage of the Standard & Poor 500. The S&P 500 is a capitalization weighted index meaning you multiply the price of a stock by the number of shares to get its weighting. If a stock is rising rapidly its weight in the index will increase. So the S&P is always most heavily weighted in popular and therefore, expensive sectors.

This is not the best strategy to make money. You don't buy things that are expensive where the future has already been discounted. You buy things that are cheap. This is how we operate here. We look for value ideas, meaning things selling inexpensive relative to earnings and assets. Because so much of life (and finance) is random and the future is so uncertain we don't want to pay too much for it. Or as Jim Grant of *Grant's Interest Rate Observer* notes, "Good things happen to cheap stocks." A piece of good news can send a downtrodden stock soaring while continued bad news often has little effect because all the sellers have already gotten out.

Why don't investors do better at buying what is cheap and avoiding what is overpriced? The reason is we are all hard wired with psychological baggage that makes success difficult. Terrance Odean of the University of California has studied individual investors and psychology for many years. In a recent CFA Institute Conference article he identified four mental biases which make it difficult for us to do well.

The first is overconfidence. We have all heard how 80% of drivers consider themselves above average. In finance overconfidence gets translated into thinking we know more about the future than we actually do. And if we know something about the future, we trade. Usually too much. Daniel Kahneman, the behavioral finance expert and a Nobel Prize winner, notes "it is expensive for people to have ideas." Study after study has shown that the more mutual funds or individuals trade, the more likely they are to

underperform. But we keep doing it. The hard wiring is just too difficult to disconnect. And remember you alpha guys, men tend to be more over confident in finance than women; they trade more and therefore they often perform less well. Ever wonder why Hanson Investment has two women to one man on the investment side. Now you know.

A second psychological problem is we don't look at everything the same way. When our stocks go up we are elated and when they fall we are distressed. We are reluctant to sell our losers because then we have to finally face up to the shame and regret of the original buy. This is not rational behavior but we do it anyway and miss out on opportunities.

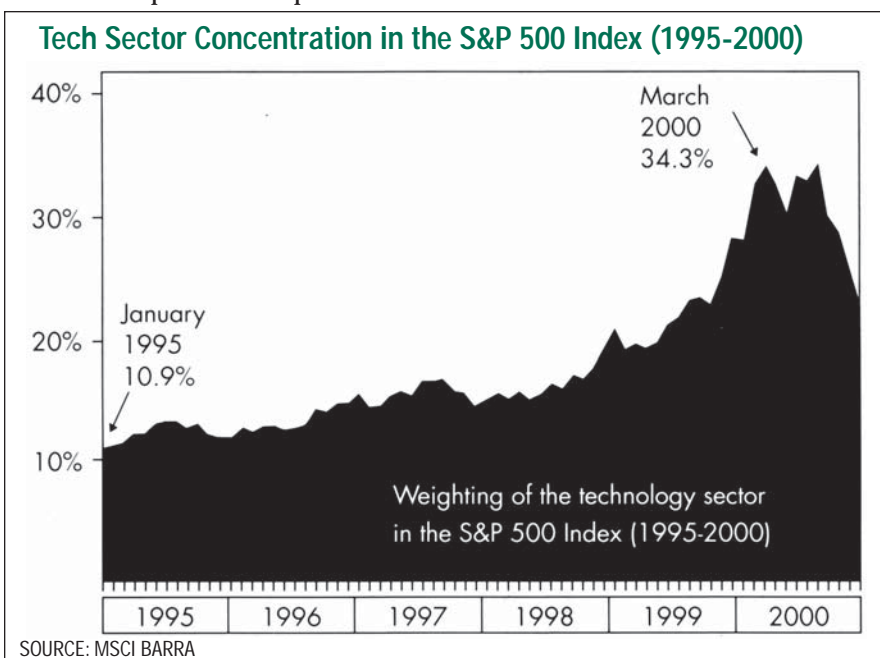
A third limiting factor is we don't see the whole picture. We see things that catch our attention. In a recent study three academics looked at 549 cover stories on individual companies in *Business Week*, *Forbes* and *Fortune*. They found that the companies which were most praised in the cover stories underperformed in the stock market in the future and those that were panned started to recover. The praised stocks had already been doing very well prior to the cover story. Their prospects were in general already discounted. On the other hand the panned companies were

down in price. The cover story acted as a kind of signal that the worst of the news was over.

The final investor trait is the one Odeon sees as the most dangerous. It is chasing trends. In mutual funds the biggest inflows are always to funds that have the best recent performance. But by definition these funds are more expensive and more likely to underperform in the future. Individual investors move in herds. They like to buy and sell the same stocks others are buying or selling. There is warmth and comfort at the center of the group, but unfortunately not much profit.

How do you avoid all this hard-wiring? The answer is we probably can't but we can minimize the damage. We can trade less often. The turnover of the average stock mutual fund today is 100%. This is not investing in our mind; it is speculation. We also try hard to think for ourselves. It is never easy to go out on a limb and buy what is out of favor but this is where the big long term money is made on Wall Street. Buy 'em when they are cold.

And finally we need to understand there is a lot we just can't understand. The world is not all random but a lot of it is. Work hard but remember not to take yourself too seriously. The market will work out. Just let it.



Getting Ahead in China Can Be Harder Than You Think . . .

Say you're a multinational with a China strategy (and everyone does need a China strategy). You have capital, and you have know-how, but you need some local knowledge to help you access China's cheap labor or huge domestic market. Partnering with a local Chinese firm would seem like an obvious solution.

But using joint ventures to trade off expertise for local access has had mixed results in China. In a few situations, joint ventures have degenerated into downright acrimony. That's the case with Danone, the French food company, which thought it had scored a coup by acquiring a 51% stake in Wahaha Beverage in 1996. Now the two companies are locked in such a bitter dispute over brand rights that Wahaha Chairman Zong Qinghou recently described Danone as a "foreign invader."

More likely than outright dispute, however, is the possibility of your joint venture partner turning into a looming competitor. That is the case with General Motors (GM), which got into China's auto industry early by partnering with Shanghai Automotive (SAIC) in 1997. The joint venture is the largest car maker in China and churns out Buicks, Cadillacs, and Chevrolets. GM views the venture as an overwhelming success, and certainly, its profitability is a bright spot relative to GM's performance in North America. The problem is that GM paid a fairly high price to get into China early on. In the mid-1990s, when the Chinese government decided to go full steam ahead on developing its domestic auto industry, it invited in foreign partners only if they agreed to complete technology transfer. Toyota decided that was too high a price and declined, but GM went ahead. It agreed to customize products for the Chinese market and set up an R&D center that would allow Chinese and U.S. engineers and managers to work side by side.

Fast forward to today, and GM has not had as much of a head start in China as it probably hoped for. Chinese car manufacturers have been growing up, and the increased competition has meant that car prices in China have been falling by 7% annually in recent years. Meanwhile, SAIC is a completely different company. It produces sedans that compete directly with Buicks in the Chinese market, it has ambitions for the export market, and it plans to put out a new model every year, from SUV to subcompact. SAIC has made it perfectly clear that it is focused on developing its own brand. In fact, it declared its intent to become one of the world's ten largest auto makers in the next five to ten years. Here's another telling sign: SAIC hired the former chairman of GM China, Philip Murtaugh, as well as much of the engineering, finance, and marketing talent that used to be at the joint venture. You can see where this is heading.

It is clear that Chinese firms – happy as they are to access foreign technology and expertise – will not be content to operate under foreign brands forever. Another thing to remember is that China is a vastly different place than it was just half a decade ago. As *The Economist* points out, China's "hunger for foreign investors has been sated" (April 21st, 2007, page 77). Land prices have gone up, labor prices have gone up, and China already understands how incredibly attractive its market is to the rest of the world. That means that Chinese firms feel less compelled to partner with a foreign firm unless its precise terms are met.

Still, not everything has been coming up

roses for the Chinese. In fact, some of China's best known telecom equipment, cell phone, LCD, and personal computer companies are finding out just how hard it is to compete at home and abroad with the multinationals (see box at bottom). Chinese LCD display makers simply have not been able to keep up with the tremendous R&D spending that keeps the Korean, Japanese, and Taiwanese ultra-competitive and efficient. Cell phone makers like TCL and Ningbo actually have been losing market share in China to Nokia, Samsung, and Motorola. Chipmaker Semiconductor Manufacturing International Corp. (SMIC), which had ambitions to take on the Taiwanese, is struggling to turn profitable. And perhaps the best known example, PC maker Lenovo, is falling behind in the international market. It used to rank behind Hewlett Packard and Dell, but recently was overtaken by Taiwanese company Acer for the number three spot in the industry.

The competition is getting fierce. It just goes to show you that whether you are a Chinese firm or a foreign multinational, getting your China strategy right isn't easy.

Reality Check

Many Chinese tech companies are struggling as they grow

» Shares in chip foundry SMIC have dropped by almost 54% since its 2004 IPO. U.S. private equity firms are circling.

» Top LCD makers may need a big bailout from Beijing to keep from going under as Korean and Taiwanese rivals power ahead.

» Earnings at telecom gear manufacturer ZTE plunged 40% in 2006—likely indicating similar troubles at crosstown competitor Huawei.

» PC giant Lenovo's stock price has dropped 34% in the past two years. On Apr. 19 it said it will lay off 1,400 people.

» Handset makers such as TCL and Ningbo Bird have lost ground in China to Nokia, Samsung, and Motorola.

Data: BusinessWeek, Bloomberg Financial Markets

SOURCE: Business Week

The Dollar: Up, Down or Sideways?

For much of the last decade, economists wrung their hands over the deteriorating state of the US trade deficit. Thanks to strong economic growth here at home, demand for foreign goods ranging from handbags to oil surged while exports stumbled along. At its peak in 2006, our nation's trade gap totaled almost 7% of gross domestic product (see chart). The basic problem here was that US consumers spent too much while foreigners were spending too little.

Most market strategists expected that either a major US recession or dramatic decline in the dollar (or both) would be needed to correct the import/export imbalance. But recent results have proven them wrong. About half way through last year, the trade deficit started to shrink and this positive trend has continued into 2007. Dissecting the results reveals some interesting trends. While the US trade gap with Japan and China continues to grow, deficits with most of the European Union countries, Britain and Canada are showing marked improvement.

Two factors have contributed to the improved results. The first is a major shift in global economic growth patterns. For most of the last three decades, the US was considered the world's economic engine. But thanks to the weak housing market, growth here at home is slowing while much of the rest of the world's is accelerating. Strong economic growth abroad is fueling demand for US products

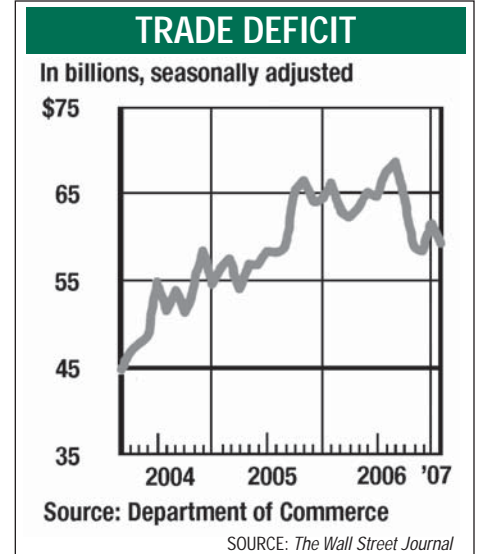
ranging from machinery to wheat to mining equipment.

The depreciating dollar has also provided a competitive boost. Since early 2002, the US dollar has fallen nearly 30% against a trade-weighted basket of currencies (excluding the Chinese Yuan). A weaker dollar makes our products more competitive in foreign markets and imports more expensive here at home.

The big question today is whether the current conditions will support a further narrowing of the trade gap. All indications suggest a supportive macro-economic environment with strong economic growth abroad continuing to fuel demand for our exports.

On the currency front, most market observers also believe that further dollar weakness is in store. This outlook is based on the assumption that foreign bankers, in an effort to keep inflation at bay, will raise interest rates, further depressing the dollar relative to their home currencies. Interest rates are the reward for holding a particular currency and higher rates abroad give our products, priced in weaker US dollars, an edge on foreign markets. Recent moves by developing and oil producing nations to diversify their reserves into other currencies could also place downward pressure on the dollar.

But a dissenting camp, led by economist and Vermont native David Hale, believes that the dollar may be due for a rebound. Hale thinks that foreigners' vast demand for US assets of all types will prevent much more of a decline.



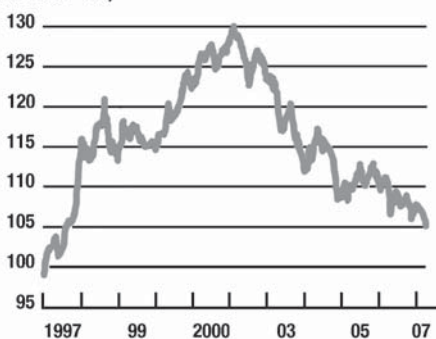
And here he has a point. Consider that foreigners today have \$2.8 trillion of direct investment in the US as well as almost 44% of the Treasury debt market, 34% of the corporate debt market and 17% of the equity market. The sheer size, liquidity and relative safety of our markets will likely continue to support foreign demand for our assets.

After a nearly five year freefall, the dollar may well be ready for a rebound. *As the chart to the left shows, the dollar appears inexpensive when compared to other currencies on a purchasing power parity basis.* Purchasing power parity provides a way of assessing the relative value of currencies by looking at the price of a set basket of goods and services in different countries. But perhaps the biggest reason to consider the possibility of an appreciating dollar is the mere fact that the consensus expects it to remain weak.

So how should investors prepare themselves for a possible appreciation of the dollar? First, currency forecasting is very tricky business and I would avoid basing any broad investment strategy on a short term dollar forecast alone. But the risk of a dollar reversal and the recent strong outperformance of international shares are good reasons to revisit your international holdings. Gradually trimming back positions that have become over-weighted remains a solid approach to risk management.

The dollar has declined . . .

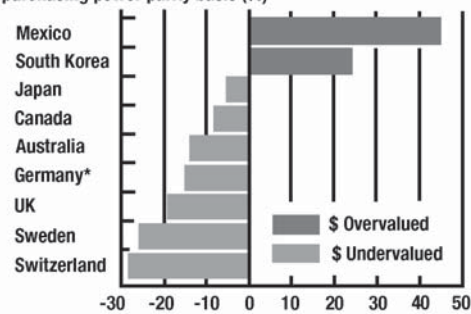
The Fed broad trade-weighted index (Jan 1997=100)



Sources: Thomson Datastream, OECD

. . . and looks cheap on a PPP basis

Dollar's valuation relative to local currencies on a purchasing power parity basis (%)



SOURCE: Financial Times

*Euro