



## Stock Market Barometer

*The Most Influential Financial Newsletter Read By Over 500 Hedge Fund Managers and Thousands of Elite Investors ~ October 3, 2011 2011*



### Quote of the month:

“the United States can pay any debt it has because we can always print money to do that. So there is zero probability of default” - Alan Greenspan

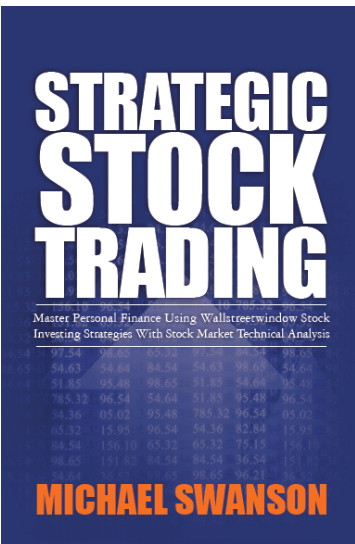
## Charlie Munger’s Incentive Superpower—Mike Swanson

This is an important issue, because I’m going to discuss with you some big changes I’m going to make to the Power Investor Service and the website over the next few months in a few minutes. I had planned on opening up the Power Investor Service on October third to a new round of people, but I have decided not to.

I know I could make some money if I let more people in, because the last time I opened it up was way back in April and I know there are a lot of people waiting to join it. But right now I just don’t want to do it.

The problem is the stock market sucks right now. In the August issue of this newsletter I told you that I really didn’t think there was much money to be made in the stock market at the time and I personally had done very little trading, much less investing, in it so far this year. In fact I have taken about half of my money and invested it in some bricks and mortar businesses, one of which will be opening up in Asheville, North Carolina in the next few months and employing over a dozen people.

The problem is the stock market has been in a cyclical bull market within a secular bear market since March of 2009 and for almost a year now every month that goes by when I look through the market I have seen fewer and fewer stocks that look like buy candidates.



This summer the bull market appeared to be tired and getting worn out and the consequences of this was the big correction in August and the current up and down movement we have been seeing for the past six weeks or so.

I still doubt that we are heading for some big bear market or wipe out like in 2008 as some seem to think, but the upside potential on the market now is severely capped. To me I think things are setting up for a big sideways range for another year once the market gets out of this current funk, but either way we no longer are in the big bull market type conditions we saw last year or the year before so the opportunities to make money investing in the market are very limited right now.

The only bull market I see now is gold and it is going through a correction right now too. I do think there will be long-term buy points in several markets next year outside of the US where there will be real opportunities to make money and I'll discuss this and the market in much more depth in a video this week where I can show you what I'm talking about.

But right now I really need to talk to you about the changes I plan on making to my services and the website and why.

Right now I simply do not see any good way to make money in the stock market. I can see some stuff that will be worth buying and holding probably in the first half of next year, but not right now. And as far as trading I'm personally not interested in trying to daytrade the market and in the end more money is made by being patient and letting opportunities come then trying to jump in and out and all over the place - the problem is even if you are successful at doing this such rapid fire trading makes you get distracted from long-term trends where the big money is made.

Successful investing requires one to step back from time to time to analyze the market and spot great opportunities. Constant trading causes people to miss the forest for the trees. I've been doing a lot of thinking about where I want to go with the market.

I'm not trying to discourage you about the stock market. Even though I have put some money into some alternative investments, there is no better way than I know of to make money than in the stock market in the long-run.

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In fact I am considering starting another hedge fund once this secular bear market comes to an end, something that will probably happen five or six years from now.

So you can see I have been thinking way out and about the big picture of the stock market and what I'm doing in it and want to do.

When it comes to investing one of the biggest lessons I've learned is that people's investment actions and beliefs almost always do not coincide with what is the best thing to do in the stock market, but what pleases those people around them.

I touched on this in my own book Strategic Stock Trading when I discussed in it why stock brokers, investment advisors, and mutual fund managers are almost always bullish on the stock market - if they are bullish and wrong their clients won't leave them, because everyone else they know is losing money, but if they are bearish and wrong their clients will take their money elsewhere - so the typical money manager has an incentive to be bullish no matter what. That's why in bear markets you hear so much talk from these people about how just holding on will pay off in the long-run. They try to make out that this is "being tough" instead of being stupid.

One of the best selling investment books of the past few years is The Big Short by Michael Lewis. He demonstrates this sort of theme throughout his book and shows how it led to the banking collapse of 2008. One of the themes of his book is that people act in the way that they are incentivized to do so - and I'd add that even if such actions are not good in the long-run they always convince themselves that they are right.

Of course this doesn't just apply to investing, but everything people do. It is a key to understanding human nature and the motivations of the people around you, and even yourself.

One of the books I recommend on my website is Poor Charlie's Almanack, which consists of excerpts from speeches and writings by Warren Buffett's business partner Charles Munger. I've actually never read the entire book and have it on the list because of one chapter in the book towards the back titled The Psychology of Human Misjudgment.

I think it is that valuable that it makes the price of the whole book worth it.

In this chapter he lists twenty-five things that lead people to make mental errors. I'm not going to talk about all of them, but want to talk about two of them.

Let's start with number one on his list: Reward and Punishment Superresponse Tendency. This is very similar to the Lewis idea of people acting in ways that they are incentivized to do so. Munger writes that "I think I've been in the top five percent of my age cohort almost all of my adult life in understanding the power of incentives, and yet I've always underestimated their power."

Munger says, "one of my favorite cases about the power of incentives is the Federal Express case. The integrity of the Federal Express system requires that all packages be shifted rapidly among airplanes in one central airport each night. And the system has no integrity for the customers if the night work shift can't accomplish its assignment fast. And Federal Express had one hell of a time getting the night shift to do the right thing. They tried moral suasion. They tried everything in the world without luck. And, finally, somebody got the happy thought that it was foolish to pay the night shift by the hour when what the employer wanted was not maximized billable hours of employee service but fault-free, rapid performance of a particular task. Maybe, this person thought, if they paid employees per shift and let all night shift employees go home when all the planes were loaded, the system would work better. And, lo and behold, that solution worked."

"One of the most important consequences of incentive superpower," Munger argues, "is what I called incentive-caused bias. A man has an acculturated nature making him a pretty decent fellow, and yet, driven both consciously and subconsciously by incentives, he drifts into immoral behavior in order to get what he wants, a result he facilitates by rationalizing his bad behavior."

I would argue that the behavior people do that leads to them making mistakes is usually not immoral, just simply in error. But either way people rationalize what they do and convince themselves they are doing the right thing.

This leads the other tendency I want that Munger talks about that I want to share with you and that is the "Doubt-Avoidance Tendency." In short, as Munger writes, "the brain of a man is programmed with a tendency to quickly remove doubt by reaching some decision."

The stock market is full of uncertainty, in fact if anything defines the market it is uncertainty. To escape it people usually do very little thinking at all when it comes to investing and trading and make quick snap decisions and judgments.

They rarely think about what is actually happening in the market and simply repeat the behavior that they think is appropriate or lead to the outcome that they hope for. That could mean holding on to falling stocks or making rapid fire manic trades that simply churn their account over.

What they don't do is set back and really look at what is happening. So right now there are people who are jumping in and out of the market making a mess, because they want to make money, when in reality it could be they should step away from it for awhile.

But this goes beyond investing and trading, but to everything people do. So for example take a police officer. A cop has a dangerous job and has an incentive to be aggressive towards people and mean to them in order to protect himself from danger. That means treating people not as individuals but as objects and often in a manner that would be unacceptable if they were not in uniform. They justify such behavior to themselves by thinking that the world is black and white and they are good while others are bad.

Much of the prison population is made up of drug addicts. A prison guard may come to think that people who use drugs are incurable, evil, and ruin society while a church pastor may think they should not be in jail so they can be in church so they can be saved by Jesus.

A Federal Reserve Chairman whose only option to try to stimulate the economy comes to believe that printing money is the solution to everything even if such behavior can cause distortions to the economy that causes even greater long lasting damage than a temporary recession.

People believe what it is in their interest to believe according to the conditions around them and their own position.

In the stock market you make money by having your beliefs and actions aligned with the reality of the market. When the position a person is in makes it so they have an incentive to believe in things other than the real trend of the market they eventually lose money.

This is the cause of the 2008 bank collapse and the current debt crisis in Europe.

It is one of the most important things about investing there is and everyone underestimates it.

I have thought about this for over the past year and have made fits and starts to make some changes to my services as a result. In the end my goal is to make money in the stock market by being as objective as possible and share my thoughts with you.

This is easy to do in free blog posts and this monthly newsletter, but I also run what amounts to a trading service and in it people expect stock picks and trades.

This is all good when the stock market is in a clear trend and there many trading ideas at hand, but it puts me in a bad situation when I really see no great opportunities in the stock market and this has been the case all year and is likely to continue to be the case for the rest of the year.

Oh yes, we'll probably get some sort of rally after this current funk comes to an end, but it will be a countertrend rally back up to some resistance point. It's nothing to get that excited about.

But many people sign up to the Power Investor Service with a get rich quick mentality. They want to make money right now and don't have the patience to wait a few months, much less a year if that is how long it takes for something great to really line up.

I'm in a damned if I do and damned if I don't position. If I tell these people I don't think see any good trades they get angry and I can't just give them trades for the sake of keeping them happy or they will lose money and get pissed off. So whatever I do in times like this there is always a group of people that are going to get upset.

So that is why I am not opening up the Power Investor Service this month. I probably won't do so until January.

What I plan on doing is making some changes to the service in the way I

present it and market it in order to attract the type of people who I want.

Instead of a trading service I want to make it the type of service that institutions and high net worth individuals would subscribe too. Those types of people don't chase after stock picks, but instead look for more in depth information on market opportunities.

An institutional type investor or money manager wants a concise report and the opportunity to talk to the person who put it together. Stan Weinstein for example puts out a monthly stock market report with charts and his analysis of the market that costs over \$20,000 a year. That sounds expensive, but the people who subscribe to it also can talk to him on the phone.

I don't plan on charging \$20,000 a year, but I do plan on jamming up the price of the service substantially the next time I open it up. Don't worry if you are a current member of it you'll be locked in for life at your current price.

What I've found is that the more I charge for something the more people use what they pay for and the less crazy they act when it comes to customer support. The less you charge the more refunds you get and silly threats of lawsuits for a refund.

So at this point I rather have a few customers to the Power Investor service paying more money than masses paying a little bit, even if it means making less money overall. It doesn't really matter to me at this point.

In the end I want to attract the type of customer to the Power Investor Service that could invest in a hedge fund one day if I decide to start another one again down the road and not the get rich quick types.

The newbie and Homer Simpson type can start out with my book and the free content on the site and the best of them can then graduate from there if they want.

I also think the service can be improved on our part by making it more concise. We are putting out a new post about every day of the week and that is making it so we are putting out a bunch of noise like you get

turning on CNBC. We are talking too much about meaningless fluctuations in the market - day to day trends - and not enough on the big trends of the market and what we are actually looking to make money in. I fear people who read the daily noise posts miss what we are really looking at in the big picture.

What I plan on doing for the Power Investor Service is making its focus two in depth PDF research reports a month with a discussion of the big market trends and then charts of stocks and sectors we are looking to buy now or are looking at as possible investments later.

Andy, Kevin, and I will then put together a video in which we'll talk about the report together and if you have any questions you can give them to us too. From these two reports and the conversations that go with them people will know what we are doing and planning on doing.

Between these two reports we're just going to do a post or video when something important is happening instead of every single morning.

I also plan on beefing up the free parts of the WallStreetWindow website by adding more writers and creating a message board forum for everyone to join before the year is over. The idea is to have more content on the site to attract more visitors and then more things for people to do when they get to the site so that they will use it more.

You'll hear about this more later from me, but for now we are focusing on the Power Investor Service and the current members of it.

This is a little unusual newsletter, because I barely talked about the market with you. I just had a lot on my mind and want you to know where I'm headed with everything. I'll put a video together about the market in

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