

# Market Outlook

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### **The Fox, the Hedgehog, and the Economist**

In a now famous 1953 essay on Russian author Leo Tolstoy, Isaiah Berlin resurrected the idea of dividing the world into people who were more like foxes, and those who thought like hedgehogs. Originally found in Greek poetry, the hedgehog "concept" essentially said that the wily fox knows many things; the lowly hedgehog "knows one big thing." Scholars have differed about the correct interpretation of these dark words, which may mean no more than that the fox, for all his cunning, is defeated by the hedgehog's one defense.

Berlin expanded on this concept to figuratively include the world of writers (his main topic) and maybe humans in general. There exists a great chasm, he wrote "between those, on one side, who relate everything to a single central vision, one system less or more coherent or articulate, in terms of which they understand, think and feel—a single, universal, organizing principle" and others on the other side, those who pursue many ends, often unrelated and even contradictory." The first view of the world is that of the hedgehog; the second, in all its complexity and confusion, represents the world of the fox.

#### **Wall Street's Foxes**

The myriad economists that inhabit Wall Street are a lot like foxes. They pore over reams of data that that pour in from government and private agencies. They analyze, they slice, they dice, and they correlate. They play an endless game of connect the

dots in order to relate the past to the present, and weave the complex elements of the modern economy into a single forecast. Worst of all, *they try to make predictions.*

Unsurprisingly, they are often wrong. A correct prediction is often hailed as a rare event by the Wall Street Journal, and the lucky economist gets to wear the mantle of "guru of the day" until his or her next prediction (which is now required) comes to naught, and a new guru is crowned.



**Meet your new investment analyst**

This past autumn, Colorado's *grande dame* of economists, Tucker Hart Adams, made newspaper headlines by predicting the U.S. will be in a recession within a year, putting the odds of occurrence at three-in-four. She set a timeline for the downturn to start as the second half of 2007, attributing slower job growth and a stalled housing market as the catalysts.

"This year, I am saying there are problems and giving you a date. We will have a negative quarter before the year [2007] is over," she proclaimed to a

business conference in Denver.

Well, foxes will be foxes no matter how many times their predictions go awry. The important question for investors is this: "So what?"

#### **The One Big Thing**

The stock market clearly outfoxed the learned majority on Wall Street this summer. Rather than nosedive on fears of a housing market collapse, the Iraq war, and inflation, stock markets rose through the summer and fall. Not even the Republican loss of their majorities in the U.S. House and Senate could shake stocks. By over-analyzing the potential

“bad” events that *could* occur, many professionals were caught on the sidelines as the market rallied. So much for relying on the past as a guide to the future.

The one big idea is this: It’s What You Own That Counts. Good stocks (and mutual funds) will always help you, good market or bad. Poor stocks, on the other hand, will always hurt you, no matter what the market, economic, or political environment. Many will say this is simple to the point of being overly simplistic, but the truth remains. *Predicting the market is not nearly as important as participating in the market.*

One of the best tools for gauging whether you are participating in the market is “relative strength,” a measure of the relative performance between a stock (mutual fund) and the market (typically the S&P 500 is used). Relative strength is a directional tool; there is no magic number that indicates a “good” or “poor” value. A rising relative strength trend line indicates a stock is performing better than the market, while a falling line indicates an underperforming stock.

The bell shaped curve of a “normal” distribution is a familiar sight. In investing terms, the market index is at the center, representing the average. Below-average performers will lie to the left of the market, while above-average performers are on the right side of the curve. Relative strength, simply put, makes it clear which side of the curve your stock lays. Rather than try to guess where the average will end up, doesn’t it make more sense to know where your portfolio is in the relative strength continuum?

Consider the example of two cars driving down the highway. The “market car” is a Volkswagen Beetle,

and the “hot stock” car is a racy red BMW. Let’s say the market car is going 55 mph and the hot stock is going 85 mph. This is the speed in absolute terms, and can be likened to the dollar price movement of a stock. But in relative terms, the market car is going zero mph, and the hot car is going 30 mph. The hot car is on the right hand side of the curve; this relative difference is what relative strength analysis tries to capture. This would be plotted as a rising trend line.

If smoke suddenly trailed from the hot car and it slowed to 75 mph, then 65 mph, then 55 mph, it would have lost all it’s relative strength, and would now be equal to the market car in relative strength. As the hot car fell to 45 mph, the relative advantage

shifts to the market car, and it moves to the below-average, left hand side of the curve.

Of course, we all know that speeding down the highway does us little good on a cross-town trip, as we only gain a few minutes, at best. But investing over a lifetime is more akin to a cross-country trip, from Los Angeles to New York. On that scale, the relative advantage of speed may add up to an entire day saved. Moreover, each year of investing can be viewed as an iteration of that nationwide trek, and the cumulative

benefits of relative strength can provide an enormous advantage in material wealth, and the peace of mind that comes with following a simple discipline.

Like the fox (and the economist) we can expend a great deal of energy, time and worry analyzing an endless stream of always-changing (and often contradictory) data while trying to form a prediction of the future. Or, we can be more hedgehog-like and take comfort in a single simple concept that has stood the test of time: It’s What You Own That Counts.

