



RAY'S CORNER

Ray L. Lent *Chairman,*
Portsmouth Financial Services

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Economic and Market Commentary

In a quiet corner of the cemetery of All Saints Church in Upper Norwood, South London, lies the grave of Admiral Robert Fitzroy, a most remarkable man whose contributions still affect all of us even today. But history has all but forgotten him.

As a young toddler, the maids, butlers and nannies would chase young Bobby up and down the stairs of an ancient Ampton Hall in Suffolk, England. Born into a family of British aristocracy and a tradition of public service, his lineage could be traced back to lords and admirals, even to England's King Charles II himself. His was a young mind grounded in responsibility and inquiry, and he was convinced from an early age that great adventures would lie ahead.

By the time Robert was 12, he entered the Royal Naval College in Portsmouth. The following year, 1818, he had completed his studies with distinction and joined the Royal Navy. A few months later, not quite 14, he was assigned to the frigate HMS Owen Glendower and sailed for South America. By the time the tour was over some two years later, Robert had returned to England six inches taller and had now been promoted to midshipman. After a short time at home, he was back at sea serving as a midshipman on the HMS Hind.

He flourished at sea and studied hard. By the time he was 19, he had sat for his lieutenant's exam and became the first midshipman to ever pass the exam with a perfect score. This bright and capable young man's talents were soon spotted by the Admiralty, and in 1828, Rear Admiral Sir Robert Waller Otway appointed Fitzroy his flag lieutenant aboard the HMS Ganges. The Ganges was stationed in Rio de Janeiro when Otway soon told Fitzroy that he had a temporary assignment for him, an assignment that would prove later to be a turning point in the young man's life.

First Command

At the time, two Royal Navy ships were conducting hydrographic surveying for the government off the southernmost coast of South America. They were the HMS Adventure, under the command of Captain Phillip Parker King, and the HMS Beagle, under the command of Captain Pringle Stokes. Captain Stokes had just shot and killed himself after fighting years of depression, and now young Fitzroy was being appointed temporary captain of the Beagle and charged with completing the survey.

On December 15, 1828, a 23-year-old Fitzroy took over the demoralized command to survey some of the most treacherous coastal waters of the world off the coast of Tierra del Fuego and Patagonia.

Red Sky at Night, Sailors' Delight; Red Sky at Morning, Sailors' Take Warning

Heavy weather at sea has been a mariner's peril since the earliest days of the Phoenician traders. Reliable weather predictions were little more than a dream. Ancient civilizations appealed to the gods of the sky for guidance. The Egyptians looked to Ra, the Greeks to Zeus, and the Norsemen looked to Thor. Ancient Aztecs would make human sacrifices to the God Tlaloc, and Native Americans would perform rain dances.

It was the ancient Greeks who first tried to apply science to weather prediction and invented the term "meteorology." Aristotle tried to explain changes in the weather through the interaction of earth, fire, air and water in his text, "Meteorologica." Aristotle's student, Theophrastus, picked up the work from his mentor and wrote the definitive weather text of the next 1500 years, "The Book of Signs." For the most part, none of it was worth much more than reading tea leaves.

Not until the Renaissance, sometime in the early 15th century, did man eventually admit that the observations and speculations of natural philosophers were inadequate in understanding our atmosphere. Scientific instruments were needed to measure the properties of the atmosphere such as moisture, temperature and air pressure. And then it started to happen. Leonardo da Vinci invented an instrument for measuring humidity called the hygrometer. Later, Galileo Galilei invented the thermometer, and his student, Evangelista Torricelli, invented the barometer for measuring air pressure. Eventually Sir Isaac Newton tied many principles together. Applying physics and mathematics, he accurately described our atmosphere and provided much of the foundation for today's modern meteorology.

Back in 1828, however, there were very few people making these scientific observations, and those that were, had little or no contact with each other. Remember, the telegraph had not been invented yet, and there was no central depository for observations. Sailors had to rely on their own skills and instincts to survive.

It did not take long

The HMS Beagle was a 10-gun brig. These ships had a high center of gravity and a tendency to turtle in heavy weather. British sailors referred to them as "coffins." A few weeks after taking command, Fitzroy had readied his ship and prepared to take it back out to sea. Here in North America, we have a term for huge storms that are frequently preceded by significant temperature drops. They are referred to as "nor'easters." In the southern hemisphere, they are called "pamperos," and unknowingly Fitzroy was about to sail into the teeth of one of the worst of them.

Caught by surprise at the ferocity of the pampero, Fitzroy almost lost his ship and all on board. The Beagle nearly capsized and was in imminent danger of foundering on the rocks. Two seamen were blown overboard and drowned, and a humbled Captain Fitzroy recognized that he had tragically underestimated the impact of this storm, a lesson that would stay with him for the remainder of his life.

Second Voyage

For three more years, the Beagle and the Adventure stayed on station and completed their work. In 1831, a seasoned and much wiser Captain Fitzroy returned to England to great acclaim for his extraordinary survey work and there met then hydrographer to the Admiralty, Sir Admiral Francis Beaufort, the same Francis Beaufort who invented the Beaufort wind scale. The two men became friends, with the older Beaufort taking keen interest in his young protégé, convincing the Admiralty to appoint Fitzroy to a permanent posting as captain and sending him back down to South America for a second voyage of survey and discovery.

This time, Fitzroy spared no expense in making sure his ship was outfitted with the best technology of the day. The ship was literally rebuilt from the keel up. Lightning protection was added, the most modern barometers of the day installed, and then there was the human factor. Recognizing that he himself was subject to fits of depression, or what he referred to as “black dog days,” and remembering the fate of his predecessor, Captain Stokes, Fitzroy was intent on taking someone with him on the voyage with whom he could socialize and in whom he could confide, someone who shared his scientific curiosity and someone who could be a real confidant. He asked his mentor Admiral Beaufort to help him find that someone.

The Envelope Please

After extensive efforts to find a suitable companion, an invitation was finally extended in the fall of 1831 to a 22-year-old graduate from the University of Edinburgh by the name of Charles Darwin.

On December 27, 1831, the second voyage of the HMS Beagle began from England. What was planned as a two-year expedition, turned into a five-year circumnavigation of the globe. When it was over, Charles Darwin published his diary, “The Voyage of the Beagle,” to international acclaim, and Captain Fitzroy returned with a wealth of weather-related information and was awarded a gold medal by the Royal Geographic Society in 1837.

No One to Sit Still

On his return, Fitzroy set about writing his half million word account of the voyage. By 1841, he was elected a conservative member of Parliament representing Durham in the House of Commons. Fitzroy married, fathered four children, and in 1843, was appointed Governor of New Zealand. His tenure there was turbulent in large part brought about by his unpopular support of the indigenous Maori people in their fight to protect their property rights from unscrupulous white settlers.

Upon his return to England in the mid-1840s, Fitzroy was appointed Superintendent of the Royal Naval Dockyards at Woolwich. His final sea command came in 1849, when he was appointed captain of the new screw (steam powered) frigate, the HMS Arrogant.

His health soon declined, and he retired from active duty. In 1851, he was elected to the Royal Society with the support of 13 fellows, amongst them the most vocal of his supporters, Charles Darwin and Admiral Beaufort.

The World's First Weather Man

By the early 1850s, great international interest was developing in the weather sciences. Since the telegraph had gained great acceptance and was connecting the world in a way unthought of just 15 years earlier, it was realized that weather observations from far-distant locations could be collected in a matter of hours and plotted on a map to give a snapshot of current weather conditions (today we call this a synoptic weather chart).

Because Fitzroy had shown great knowledge and insight on weather at sea gleaned from his years as a captain, in 1854 the president of the Royal Society, Lord John Wrottesley, nominated him chief of a newly formed government board on meteorological statistics. The goal was to improve the safety of sailors and fishermen by making weather information readily available. The board worked tirelessly on improving barometric instrumentation, including the invention of the storm barometer that still bears his name, the Fitzroy “Storm Glass.”

They located ships' captains willing to undertake the gathering of weather observations while at sea and supplied the ships with a set of instruments that had been tested for standardization at the Kew Observatory. By 1855, no fewer than 50 merchant ships and 30 Royal Naval ships had been outfitted with the new instruments. They constructed weather charts which could find the recurrent patterns that foretold hazardous conditions at sea and then could be used to give warnings of dangerous weather. Fitzroy referred to this predictive process as, "forecasting the weather." Eventually, the term was shortened to "weather forecasts."

In 1859, a natural disaster occurred that cemented in both the government's as well as society's mind the importance of Fitzroy's work. In mid-October, a major storm moved across Britain and eventually out to sea, causing much damage across its path. Many vessels were lost, including the Royal Charter with all 450 people on board. By the following year, an official storm warning system was in place. Daily observations were transmitted from stations all over Europe and Britain.

On February 6, 1861, the first official warning was issued using cones and flags during the day and lights at night. That first year 50 warnings were issued, and the following year saw over 130 warnings issued. The system proved successful and countless lives were saved over the years because of it.

Regrettably, these Herculean efforts took their toll on Admiral Fitzroy. Exhaustion set in, followed by a return of depression. The black dog days had returned, and on April 30, 1865, Fitzroy committed suicide. A grateful nation mourned the loss of the world's first weather man, and Queen Victoria insisted that Fitzroy's widow move into Hampton Court Palace, where she lived until her death.

So What's the Connection

A financial writer and analyst I have followed for many years named Dick Young once wrote, "I am the weather man, not the weather." In other words, a weather man can't prevent the rain, but he can send you out prepared most of the time with a raincoat and umbrella. A good financial advisor should be able to do the same.

One of the great challenges we face in our lives is how we respond to the things we can't control and don't like. Take your pick. This past year, who liked a Greek default, a Chinese meltdown, interest rate hikes or a drought? Nothing stands still, but you can prepare, you can have a strategy.

A Concept Called Behavioral Finance

Back in 1979, two psychologists by the names of Daniel Kahneman and Amos Tversky introduced "prospect theory." Prospect theory outlines a set of disciplines used to understand how the framing of risk influences economic decision-making. The work centers on risk attitudes, mental accounting and overconfidence.

Risk Attitude: Classical economic theory argues that investors are risk averse. Behavioral finance holds that, left to their own devices, most investors are risk inconsistent and operate on a continuum bordered by fear on one side and greed on the other.

Mental Accounting: Classical economic theory argues that money is interchangeable, fungible. In other words, one dollar is as good as another. In mental accounting, people tend to treat money differently depending on its source. Here's an example of how it works and why it frequently slows progress toward achieving our financial goals.

Studies show that gamblers rarely leave the casino as winners. The reason is not simply because the house has an edge on every game. Mental accounting is also the problem. Gamblers consider their winnings as house money and reason that they can keep on gambling for free. So most gamblers only stop playing when they are losing.

The Effects of Stock Market Volatility on Human Emotion

Overconfidence: Classical economic theory argues that investors are rational decision makers who use the financial information that is available to them. Behavioral finance holds that investors are prone to overconfidence and biased decisions. Tversky and Kahneman found that investors were often overly optimistic about investment decisions, overestimating the chances of financial success and overestimating their financial knowledge.

Here's a case in point. A few years ago, a major discount brokerage firm reviewed more than 8000 paired trades. (The investor sold something and then immediately bought something else.) The stocks that people thought about and decided to sell consistently outperformed the things that they then bought, a result confirmed by any number of other studies. In fact, these findings caused one behavioral scientist to conclude that the cost of an investor having a thought is about 3½% at an annual rate.

This past year, equity markets have seen increasing volatility, and it is my firm belief that greater volatility is on its way. Not to be a statistic-spouting wonk, but keep this in mind. From 1950 until 1999, the S&P 500 Index rose or fell by 2% or more an average of five times per year. Between 2000 and 2011, that average jumped to 12½ times per year for advances and more than 14 times for declines. It has been almost four years, however, since the stock market had its last 10% correction. So, the thinking here is, as conditions weaken and a bull market starts to morph into a bear as it always does, at some point, will the average investor be prepared, or will they react to emotion?

From a behavioral finance perspective, a market cycle will evoke the following set of emotions to the undisciplined investor. When a market has topped and starts a decline, apprehension first sets in. If the decline continues, apprehension turns to fear. If declines continue further, that fear turns to panic around the market bottom, and many sell here. (Analysts call it capitulation.) As the market starts picking itself off bottom and stock prices start to go up, excitement sets in. If prices continue higher, that excitement turns to exhilaration, and around the top of the market, exhilaration turns to euphoria. That's where many "jump into the market," and the agonizing cycle starts anew for the undisciplined investor.

So, the question begs to be asked: "Where are we in the stock market cycle?" If you're not a market timer, what difference would it make if someone could tell you? And they can't. Anyone who tells you they know for sure is just guessing in the end. Everyone would be rich if it was so predictable.

Let Me Bring it Home

All too often, decision-making about personal wealth is influenced by emotions and unconscious biases that cause people to make sub-optimal choices. Often, they chase strong returns, are reluctant to reallocate portfolios and overreact to short-term volatility.

The economy is often sending mixed messages as it is right now. Business profitability is still above average. But rising wages may prove a durable challenge in the future. The Federal Reserve couldn't do much more than it is doing to support the stock market and asset prices, yet it is disturbing that they now own more than 45% of all Treasuries with greater than 10 years to maturity.

Recently, I came across an interview with an old portfolio manager that I admire from New York, Arnie Mori. Arnie was quoted as saying, "In the long run, intelligently diversified portfolios reflect a reasonable approximation of underlying value. Traders, on the other hand, are at the mercy of irrational price swings and anomalies."

You can never drive a portfolio by looking in the rearview mirror. For the better part of two years now, we have been dampening portfolio risk in anticipation of increased volatility with the inclusion of return streams enjoying low correlation to equity position. We continue to rebalance our insured components vigorously and have begun to add both managed futures and short-term secured financing instruments to our already well diversified portfolios. The more uncorrelated, attractive return streams you can get into a portfolio, the more predictable and stable the result will be. Just because it's raining doesn't mean you need to get drenched.

Post Script

File this one under "never get complacent, never stop looking for opportunity." Presently, we are in the midst of our due diligence, investigating a very new piece of ERISA legislation just approved by the U.S. Treasury Department last summer. It's called Qualified Longevity Annuity Contracts. QLACs for short. What these contracts do is allow individuals to set aside up to 25% of their IRA balances, or \$125,000, whichever is less, in these accounts and bypass the required minimum distribution (RMD) rules, which generally require that payments begin at age 70½ with respect to a portion of their total retirement savings. QLACs are new and complex, but undoubtedly can provide significant flexibility for those who wish to take greater control of the income component of their future retirement. Stay tuned. More to follow. This fall is when we complete our investigation.



RayLent@portsmouthfinancial.com
www.portsmouthfinancial.com

Toll Free:
800.443.2227
Phone: 415.543.8500
Fax: 415 764 1064

250 Montgomery
St
Ste 200
San Francisco



PORTSMOUTH
FINANCIAL SERVICES