EUBEL BRADY & SUTTMAN
ASSET MANAGEMENT

A Fire Drill for Market Volatility - Will You Self-Inflict Unnecessary Wounds?
Part III: Behavior Management

Hypothetical scenario: you hear the anchor on a cable financial news station say the S&P 500 is down 30% from last year. You feel a sense of anxiety. After all, 30% is a significant drop and you quickly check your personal investments and 401(k) accounts. You remember that sense of achievement when you last checked and your investments had reached $500,000. Now, your stomach is queasy as you see that your investments dropped to $350,000.

What is your next step?

a. React to the fear triggered by the news and reduce stock exposure in your 401(k).

b. Reassure yourself that this is only a risk to worry about if the drop is likely to be permanent in nature.

c. Re-read part II of this series and ask your EBS investment professional if it is a good time to increase your exposure to stocks.

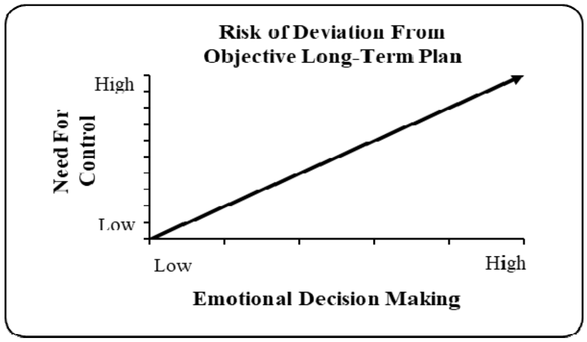
Your amygdala (which as we mentioned in part I of this series is the warning system of your brain) is applying intense pressure – to react to the stimulus that the liquidating price of your investments has declined to $350,000. The pressure is heightened by your mind's creation of an anchoring point for your investments at $500,000. To use a wrestling analogy, your shoulders feel as if they are an inch off the mat, while your brain is telling you to execute step a. above to avoid being financially pinned. This final part of our three part series is intended to help strengthen your confidence that you are likely not on your financial back, nor anywhere close to being pinned. We will also share our thoughts regarding current valuations staying above long-term averages in recent years.

There may be times during your investment journey when you feel like you are behind in your quest. Sometimes, this feeling may result from your envy of those who tout a recent investment success, and yet others will be your own internal voice second guessing in times of doubt. In reality, your amygdala probably has you tricked. So, let's identify how you can avoid taking actions that can result in irreparable harm to your long-term financial health.

Our starting point is a simple stomach test. Like spicy foods, changes in market prices (downside volatility) affect each of us differently. In contemplating the future of financial markets, the issue is when, not if, unexpected events will take place. It is certainly within the realm of possibility that a 30% or greater market correction can occur in your remaining investment lifetime. Part II of this series recounted the NASDAQ index's drop of 75% from its top in 2000, as well as the Dow Industrials drop of 54% from its high-water point in early October 2007 to a bottom in March of 2009. To have long-term investment success, one might emulate a hibernating bear. It would be ideal for an investor to totally block out stimuli that encourages a damaging response. More realistically, an investor should at least learn to screen out irrelevant short-term news – through a lens that is not swayed by emotions or need for control.

In the chart below, we attempt to highlight two significant forces that we believe must be managed to enhance one's chances of achieving long-term investment success. The need for control can strongly influence how individuals view risk: "The less we feel in control, the less willing we are to take risk," notes professor of psychology Paul

Slovic[1]. However, the more intense the need for control, the greater the chance we are fooled into believing price volatility is risk.



A starting point is to have an objective plan for reviewing your investment approach as needed in the context of actual as opposed to perceived risk. As we think about risk in the context of EBS's investment framework, it can be boiled down to being forced to liquidate an asset at a discounted price in order to create cash. Avoiding this situation requires four basic fundamentals:

- Stay anchored on the estimated underlying value of your assets, not current prices.
- Assess your need for control and recognize Mr. Market's emotions will prevent fundamentally sound valuation principles from defining prices in the short-run.
- Improve your opportunities for success by deflecting your emotional reactions to irrelevant news and focusing on the objective criteria that generally drive asset values.
- Be realistic about how much volatility your stomach can take, recognizing it has been more than a decade since Mr. Market has served anything spicy enough to really stress test the average investor's stomach.

Investing is not the same as gambling but there are similarities. In both areas, long-term success requires one to recognize when the odds are with and against them. Take Blackjack, the player and dealer are both seeking cards totaling 21 without going over (i.e. busting, the investing equivalent of permanent loss of capital) and the dealer must take a card on 16 or less. Today, when comparing the S&P 500's normalized P/E ratio to its long-term average or median, it's roughly 60% above long-term averages (in our view). We liken this to the dealer showing a ten (face card or ace) while we as investors sit with 16. We could get lucky and draw a card equal to four or five, and have a 15% chance to tie or win. However, we are much more likely to get beat given the dealer's almost 50% chance of an outcome of 20 or 21. So, looking at current valuations in the framework of our investment philosophy, we will wait for the next hand (i.e. a better time to buy) before taking the low odds of a four or five being drawn.

In summary, when Mr. Market eventually dials up falling prices, recognize the risk of hurting your own interests. The greater the need for control and the more emotions influence decision making, the greater the pressure to act. An urge to act can distort present reality since things you want to own are getting cheaper – translating to potentially more future upside. In the long-run, the discipline to focus on the objective aspects of your plan, grounded in underlying valuation principles, can be your best defense against getting financially pinned.

[1] Control freak or healthy sense of control – Psychology Today Glenn Croston, P.H.D. 21//4/12