Market Shadows

THIS WEEK

Fail, and Fail Well

"Go on Failing, Go on. Only next time, try to fail better." ~ *Samuel Beckett*

In Mindless Money 1/5: Focus on Failure, Tim Richards of the PsyFi Blog discusses the human tendency of letting our excessively optimistic nature taint our investing decisions. One remedy to this overoptimism is depression. And while depression makes us better investors, it is depressing. Few people would choose a life of misery.

Instead, Tim argues that we should suppress our rosy outlook by relentlessly examining our failures. He writes, "We know that overoptimism, anchoring, hindsight bias and a bunch of other behavioral biases are implicated in many of our poor investing decisions. We trade too much, fail to accept that our failures are our own fault, and quite often simply don't recognize that we're losing money relative to the markets."

What are these behavioral biases? Anchoring is the irrational attachment to a price that we've become familiar with, even if it is unrelated to value. We have a habit of focusing on one salient point, such as the price at which we buy a stock. If we buy stock in a company for $20, we get the idea that the stock is worth $20 and might think it's a bargain if it drops to $15. $20 is our "anchor." However, if the company's intrinsic value is only $10 per share, buying more at $15 would not be a bargain, even though it looked like it was on sale.

Hindsight bias is the tendency to believe that events were more predictable than they really were. It leads to investor overconfidence and underperformance.

Loss aversion: investors have greater risk adversity when protecting a gain than when chasing a loss. We avoid taking losses to maintain the illusion that we are skillful investors. This contributes to the estimated success rate for day-traders of only 1% to 10%.

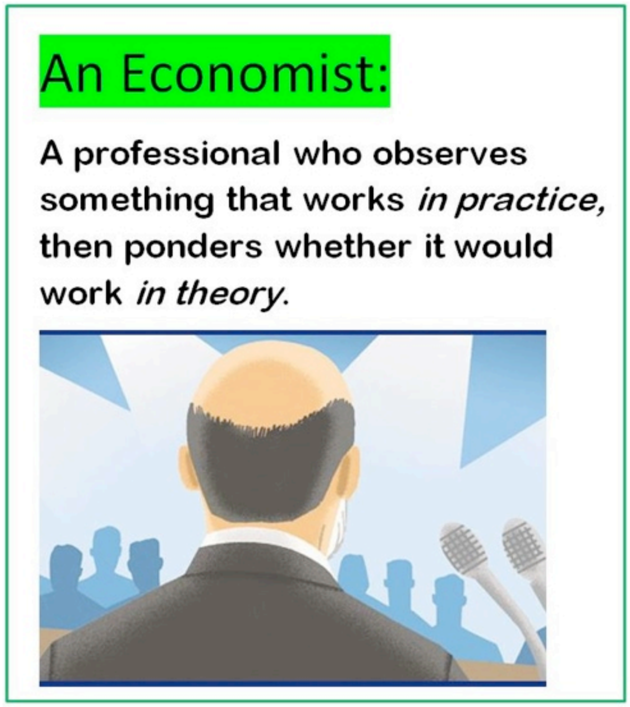
Overoptimism and overconfidence: Many investors are too confident and too optimistic. Tim notes, "80% of students think they're above average drivers, all states claim above average student test scores and, of course, most investors think they're above average moneymakers. There are a lot of seriously deluded people out there.

"Overconfidence is only one part of the equation – it's one thing to believe you have better judgement than you actually have, but it's another to be biased positively. Over optimistic people will have an unrealistic expectation of how often they'll get a good result versus a bad result..."

"Glaser and Weber ran a study on internet based private equity investors which showed that the more confident the investor was in their own ability, the more they traded."

Research by Barber and Odean showed that online traders were overconfident and overtraded. They concluded: "Overconfident investors were more likely to go online and once online the illusion of control and the illusion of knowledge further increased their overconfidence. Overconfidence led them to trade actively and active trading caused subpar performance."

Tim continues, "evidence overwhelmingly suggests investors of all kinds trade too much and damage their returns horribly by doing so. Most active investors must lose against the market – the negative



sum game by which the investment industry extracts its pounds, kilos and bucket-loads of flesh guarantees this." (Overconfidence and Over Optimism)

These and other biases cause us to ignore obvious feedback, such as losing money. They lead to mindless investing behavior, which can be counteracted by focusing on failure.

"Being preoccupied with failing may seem an odd thing to suggest to an investor, but every failure offers us many more learning opportunities than all the successes we may ever have. After all, if we succeed we may have been lucky, but if we fail we certainly haven't been.

"Not only should we conduct autopsies on our failures, we should look hard and long at our near failures as well, and we should continually review our successes to try to figure out what bad habits they may be lulling us into. Success, particularly repeated success, is particularly likely to encourage us into bad habits. A good investor should never assume that success is equivalent to competence – we need to avoid habituation and the inattention that comes from it. Simply repeating what's worked in the past is a one way ticket to a future mistake." ([Mindless Money 1/5: Focus on Failure](#))

While it's an unpleasant assault on our egos to focus on failures, our failures, more than our successes, provide feedback for improvement.

[Gold Mining Shares: Less than Glittering](#)

By Paul Price

Jesus was hailed as a miracle worker when he turned water into wine. What would the appropriate name be for the Wall Street geniuses that managed to turn a 258%, decade-long rise in the underlying price of gold into losses for investors in most gold mining companies?

The per ounce price of the yellow metal has almost quadrupled from its 2003 low point even after pulling back from its Aug. 2011 pinnacle above $1900 (chart, top right).

Almost two years later, gold sits 35.6% below the 2011 top and some pundits are now calling for $700 – $1,000 on the downside before bottoming.

True believes were not big sellers even at the peak. Many believed that fiat-based money was on its way to worthless and that gold was simply pausing on the way to $5,000, $10,000 or higher.

10 Year Gold
Chart Source: Monex.com
High 1900.30 Low 341.80

Even if they missed exiting at the top, owners of physical gold have made substantial profits over the past decade. Players who used the SPDR Gold ETF (GLD) or its equivalents ("paper gold") have also done well. The GLD did not exist ten years ago. It began trading on Nov. 18, 2004 (chart below).

Traders who chose to buy shares of gold mining companies as a way to play rising metals prices made a huge miscalculation. Shares of the major producers have posted significant losses for the past one and two years. Except for Goldcorp (GG), their price

Total Return Nov. 18, 2004 – Jul. 7, 2013 = 166.1% Source: Yahoo Finance declines dwarfed the fall in the actual per ounce price of gold.

Three of the four highlighted gold-mining shares also showed horrible results over the most recent five and ten-year periods. Goldcorp managed to record a moderate gain since July 6, 2008 and more than doubled investors' money since July 6, 2003. Still, that was substantially below the 258% percent increase of the underlying metal (table on the next page).

Less than Glittering Returns on Gold Mining Shares

Shareholder Total Returns 1, 2, 5, & 10 years

Total Return since	Jul. 6, 2012	Jul. 6, 2011	Jul. 6, 2008	July 6, 2003
Barrick (ABX)	(-59.9%)	(-66.1%)	(-61.7%)	(-10.9%)
Newmont (NEM)	(-38.5%)	(-42.6%)	(-34.8%)	(-3.3%)
Gold Corp. (GG)	(-34.6%)	(-22.3%)	+41.3%	+ 108.5%
Kinross Gold (KGC)	(-40.7%)	(-68.6%)	(-74.2%)	(-32.6%)
Source: Yahoo Finance		Total Returns = Cumulative		

Why did mining shares do so badly?

Per share production costs vary by company and geographical area. All four of the profiled companies spent from $910 – $1149 per ounce based on their 2012 "all-in sustaining costs." "All in sustaining cost" is a non-GAAP metric defined by Newmont as "the sum of costs applicable to sales, copper byproduct credits, G&A, exploration expense, advanced projects and R&D, other expense, and sustaining capital."

At today's gold price, miners' profit margins are anemic compared with the past couple of years. If gold declines much further, none of these companies would remain profitable.

Emerging market governments are having money problems just like those of Europe and America. Politicians in many countries are trying to renegotiate valid contracts with miners to dramatically increase royalty payments. This is a serious threat. Multi-billion dollar capital investments in foreign lands can't be picked up and moved elsewhere. Legal remedies are ineffective. They are costly, time consuming and hard to enforce even if successful.

Environmental groups are pushing for tighter controls on waste treatment and disposal of toxic materials needed for processing ore. At best, this will make business more costly. At worst, it could kill production entirely in some areas.

Every mining company depends on replacing their proven reserves. They do this through exploration and/or more efficient extraction techniques. The low-hanging fruit has been picked. Long term shareholders should be concerned by this.

Multiple Problems for Mining Companies

- Increased costs of mining
- Political friction from host governments
- Environmental issues
- Replacement of reserves
- Falling gold prices (last but not least)

If you hope to profit from a resurgence in gold, you are better off owning physical gold or gold-based ETFs. Avoid mining shares which have severely under performed and have every reason to continue underperforming.

Previous Articles on Gold:

What have you done for me lately? Precious (metals) little.

All That Glitters…

Hidden Dangers in Gold – Part One.

Hidden Dangers in Gold – Part Two.

Gold's 'Highly Inflated' Track Record.

Mettle Trumped Metal.

Virtual Portfolios - Performance Updates

Our value-oriented stocks continue to reward our Virtual Value Portfolio with outstanding gains. Our $100,000 virtual account had grown to $123,588 (+23.6%) through the close on Tuesday, July 9, 2013. We are pleased with both nominal returns and our results versus the S&P 500.

We sold one position (HSII) last week for a 44.6% gain. Now we will retain $4,455 in our cash reserve and wait for the next great buying opportunity.

View all open and previously closed-out positions in the Virtual Value Portfolio here.

After our recent put selling binge, we're happy to stay with the current batch of short puts. 18 of 19 of our current open positions would be profitable if today was expiration day.

We have already taken profits on two closed-out option trades. View the details of Market Shadows' Virtual Put Selling Portfolio here.

QE Is Money Printing; QE Causes Inflation

By Lee Adler of the Wall Street Examiner

Here we go again with more self appointed experts repeating the big, pernicious misconceptions about what quantitative easing (QE) does and does not do. Let me put it bluntly. The ideas that QE does not cause inflation and that it's not the equivalent of printing money are categorically false, regardless of how many times you see those points made, and on how many websites. They are not true.

The idea that QE does not stimulate CPI inflation is correct. That is not the same thing as QE does not cause inflation and is not money printing. QE is money printing. It causes some kinds of inflation, but may not cause some types of inflation at a given time. Under other conditions it may. Under current conditions, it does not raise CPI [consumer price index].

QE stimulates inflation, only not the dumbed down definition of inflation encapsulated in CPI or PCE. If you dumb down inflation to exclude all the things that are inflating, then voila, there's no inflation. [Inflation reporting tricks were discussed extensively in last week's newsletter, Fables and Fairy Tales (7-3-13), in the article Say Hello to Inflation, Inflation is Dead.]

However, QE is directly responsible for asset inflation. It was directly responsible for increasing money supply dollar for dollar, but it could not drive CPI inflation. Establishment economists and their supporting cast of lying shills deliberately exclude asset inflation from their definitions of inflation. So it appears that QE does not cause inflation as narrowly defined. If you believe that narrowly defined CPI is the only kind of inflation, then stop reading now. You're in denial and presentations of fact and logic won't change that.

Same if you don't believe that QE is printing money. Prior to the central bank's purchase of the securities, the money did not exist. Subsequent to the purchase, it did. Oh sure, the Fed didn't print the money. It just created an electronic credit in the account of the Primary Dealer at the Fed. The Fed paid for the securities with money that did not exist prior to that moment. Now you don't see it, now you do. Abracadabra, hocus pocus.

[Total money supply might not appear to be inflating despite the fact that the Treasury keeps issuing new bonds to fund the federal budget deficit. That would be possible if other bond holders have been liquidating T-bond positions previously bought on margin. The unwinding of these 'carry trades' would offset the new issuance dollar for dollar.]

Absent the simultaneous extinguishment of money, the money supply has inflated at exactly the rate at which the Fed printed the money. That was the case until the end of 2012. US money supply growth stopped in its tracks at that point because big banks and other market participants began liquidating Treasuries, paying off the margin used to purchase them, extinguishing deposits as a result. Prior to that, money supply grew in perfect lockstep with QE. Offsetting forces are now extinguishing money at near the rate which the Fed is adding it to the system.

As Treasury supply diminishes (and counterintuitively, simultaneously has lately become desirable to hold) the recipients of the QE seek other ways to employ the funds. That results in an increase in the prices of other financial assets, whether bonds, equities, or futures. This works every time without failure. When the Fed prints money, asset prices inflate, and if Treasury supply is restricted other asset prices inflate more.

This is basic supply and demand. Effective demand for financial assets is increasing because the Fed is pumping cash into the accounts of trading firms. They look for places to put the cash to work. For a while it was bonds. Bond prices rose and yields fell. Housing prices rose as a corollary of the falling yields. Housing is a perfect example of prices rising 10-15% per year but not being recognized as inflation.

For most of the past 4 years trading firms also bought equities, whose supply was increasing far more slowly than the cash the Fed was pumping into the accounts of these entities. Stock prices have been rising at astronomical rates, but that's not recognized as inflation.

Why then are Treasury prices falling? The Fed is not the only actor pumping newly printed money into the pool. The BoJ, (Bank of Japan) ECB (European Central Bank), and all the world's central banks pump and drain funds from the same pond. The PBoC (People's Bank of China) also does so indirectly as some entities to whom the PBoC lends also act in the world liquidity pool.

Lately the ECB has been shrinking its assets at a breakneck pace thanks to the pay-downs of the LTRO (long-term refinancing operations) emergency loans it issued at the end of 2011 and early in 2012. The securities purchased with that leverage are being liquidated. Capital/money is being destroyed. At the same time the PBoC has imposed tightness on its players, forcing liquidation and capital destruction in the world liquidity pool. The BoE (Bank of England) has also been tight. These forces have counteracted the Fed's direct money printing, making it appear this year that money printing does not result in increasing money supply.

One thing that I agree with is "QE does not affect the wider economy in any very helpful way: its effects if anything are contractionary, because of the hit to aggregate demand for some groups caused by the depression of interest rates on savings."

This is an important point although I would not argue that QE is contractionary. The effects are a matter of transferring wealth. A benefit to one sector is a cost to another in a world that, like it or not, still functions according to the rules of double entry accounting. The accounts of the 7% are benefitting from QE. Everybody else is getting screwed. QE, i.e. money printing, creates massive distortions that eventually result in systemic reset, otherwise known as "collapse" or "crash."

The conventional inflation/deflation argument is a red herring. It's irrelevant. It's the asset inflation, the financial asset bubbles, that are the problem today, just as they were the problem in the middle of the last decade. They're a problem which few in the establishment, the same establishment that brought us the 2008 "adjustment," recognize because of the narrow definition of inflation which they promulgate. A repeat performance of the "adjustment" is coming and will keep coming until the lesson finally sinks in and the system is cleansed once and for all."

Lee's point is that QE is money printing, no matter how you want to define it. It causes inflation. An extra trillion dollars of money per year has pushed stock prices higher. We don't see this as ending any time soon.

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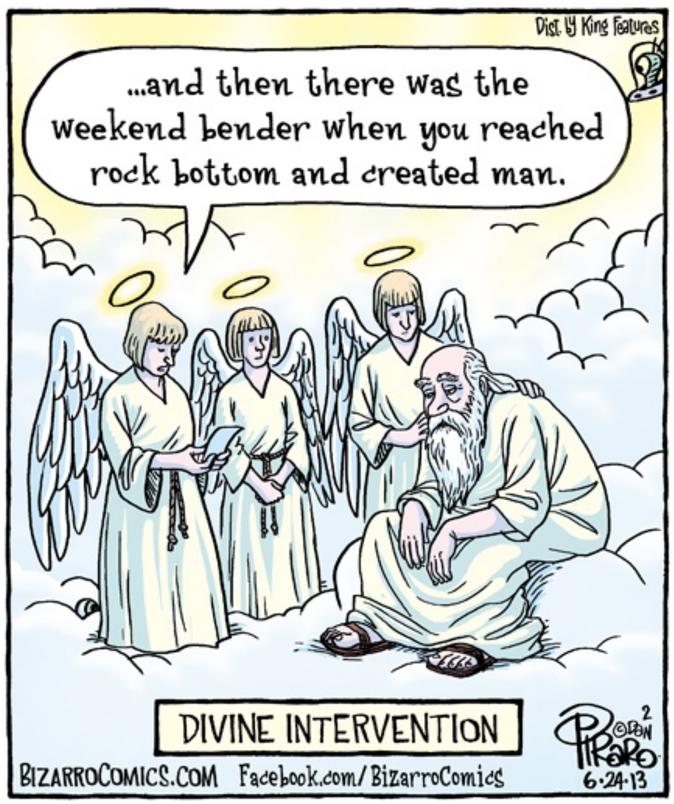

Cartoon courtesy of Dan Piraro, Bizarro Comics.