Wealth through ingenuity.

On My Radar

September 13, 2012
By Steve Blumenthal

As I dive through a broad range of independent research each week, I touch on today's QE3 announcement and include several pieces that I hope you find helpful. Following are four ***bullet points***:

- **QE3**
  The Federal Reserve decision is out and it is big. There are two main components. The first is that the Fed has extended its guidance for low interest rates through mid-2015 from late 2014. The second is that QE3 is going to be open-ended. The Fed will buy $40 billion worth of newly issued agency Mortgage Backed Securities ("MBS"), ***per month,*** indefinitely. I expect nearly $50 billion worth of both Treasury's and MBS per month. Past Fed announcements specifically targeted the amount of QE. This time, there is no stop until the Fed is happy.

  They will also continue with Operation Twist through year-end.

  I believe the open-ended nature of the program could add to longer-term inflation concerns, eventually driving yields higher on bonds with longer maturities. (Though not just yet.) Short-term maturities will remain low as the Fed holds short-term rates near zero percent. For now, deflation holds the reins. I expect little immediate inflation pressure. The longer-term risk is for higher inflation and higher interest rates.

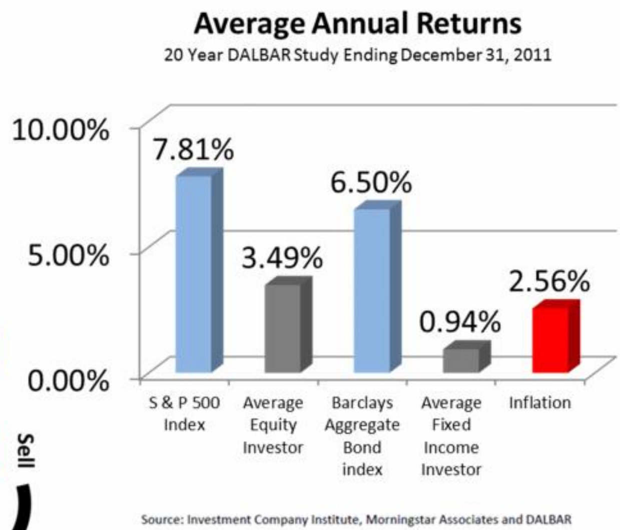
  Members of the FOMC downgraded their economic projections for 2012 to 1.7% from 2%. I believe the Fed's intention is to keep monetary accommodation in place until after the economy and the labor markets strengthen.

  Bernanke made frequent references to the housing market and said firmer housing prices would boost confidence, encourage spending, and further ease lending conditions. I believe this is what is behind QE3.

- **The Psychophysiology of Real-Time Financial Risk Processing by Andrew Lo:**
  A longstanding controversy in economics and finance is whether financial markets are governed by rational forces or by emotional responses. "Our findings suggest that emotional responses are a significant factor in the real-time processing of financial risk". As I read this white paper by Andrew Lo and Dmitry Repin, in my head I could hear the quiet whisper of the late great Sir John Templeton, "buy when everyone else is selling and sell when everyone else is buying". I hope you find it helpful. Click here to read.

- **Dalbar Study on Investor Behavior Chart:**
  Further evidence of poor investor tendencies, the chart below reflects the average individual investor's return as part of a 20 year study. The left side of the chart shows the emotional roller coaster cycle investor's experience and right hand side shows the significant

investment return underperformance that comes from emotionally buying and selling at the wrong times. This may come in handy over the next several days.



- **Updated Sentiment Charts – [Trade Signals 9-12-12]**

With this new QE injection designed to boost the markets, you may receive a number of calls from clients wishing to chase back into equities. I continue to believe that success exists within the portfolio construction process and favor a broadly balanced plan that includes a number of important non-correlating asset classes. An idea is to add to equities when sentiment is extremely pessimistic and rebalancing away when sentiment is extremely optimistic.

I recommend three allocation buckets: equities, fixed income and tactical. You'll know how much to allocate to each depending on your client's needs, goals, risk and time horizon. The key is having a plan that can keep your client on target. One last idea: consider presenting the Dalbar chart to your client every time he/she wants to chase into or out of the market at the wrong time. Coach him/her back to the plan.

The great experiment continues. The unintended consequences will unfold before us. Risk remains elevated.

With warm regards,

Steve

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