



**CUBIC ASSET
MANAGEMENT, LLC**

2010 4th Quarter Stock Market Commentary

CONFIRMATION HEARINGS

"Most people would rather die than think; in fact, they do so."
Bertrand Russell

On September 11, 2001, the United States government, working in conjunction with Israel, detonated strategically placed charges in the World Trade Center which caused the buildings to collapse. Previously filmed movie footage was distributed to the media which appeared to show commercial aircraft piloted by Islamic hijackers crashing into the twin towers. More than 4,000 Jews stayed home from work that day, having received an early warning from the Mossad of the impending explosions. Simultaneously, a missile fired from a United States Air Force fighter struck the Pentagon, although it is possible that a commercial airliner was permitted to strike the Pentagon when the Air Force was ordered to stand down. These fabricated terrorist attacks were cited as the justification for the United States to go to war in the Middle East to control American access to oil.

Incredibly, according to a 2007 Zogby poll, an incredible 26% of the American public believes the government knew the attacks were coming while 5% think they actively participated. In the Arab world the numbers are substantially higher. Fifty-nine percent of Turks and Egyptians ascribe to this fantasy, sixty-five percent of Indonesians, fifty-three percent of Jordanians and even fifty-six percent of British Muslims. Astonishingly, the more independent commissions document the official version of events (that nineteen Al-Qaeda trained hijackers wreaked this havoc using four hijacked commercial airliners), the higher the percentage who believe the conspiracy theory. And just to clear the record, slightly more than 400 Jews died in the attacks on the World Trade Center, roughly 20% of the 2,071 casualties, and considerably higher than the 12% of the New York City population who indicate their religious orientation is Jewish.

As bizarre as this type of delusional thinking seems, it is far from uncommon. In the psychological literature it is known as confirmation bias (or my-side bias), the cognitive error in which people search for and interpret data in a way which confirms their existing beliefs. We hear only what we want to hear. Contradictory data is ignored. This phenomenon has been known for hundreds of years. Sir Francis Bacon wrote the following in 1620:

The human understanding when it has once adopted an opinion (either as being the received opinion or as being agreeable to itself) draws all things else to support and agree with it. And though there be a greater

number and weight of instances to be found on the other side, yet these it either neglects and despises, or else by some distinction sets aside and rejects; in order that by this great and pernicious predetermination the authority of its former conclusions may remain inviolate.

Examples of confirmation bias are legion. In 2008, researchers at the California Institute of Technology and Stanford Business School took wine novices and measured activity in the medial orbitofrontal cortex, the part of the brain where flavor responses occur. Each participant was given two glasses of wine. They knew nothing about them except for the price. One was expensive, the other not. Unbeknownst to the study participants, the wines were actually identical. Invariably, they preferred the more expensive wine. Their brains chose to look for flavor notes confirming their view that the wine that cost more was better than the other.

Thousands of parents of autistic children persist in the belief that a preservative, thimerisol, used in childhood vaccines as a preservative, is the cause of their child's affliction. This is despite the fact that numerous scientific studies have been unable to determine any link between vaccination and autism. In litigation about the issue initiated by 5,000 parents, the Secretary of Health and Human Services appointed Special Masters for the Vaccine Court to hear the strongest cases to set precedent. Every case and all appeals were dismissed for lack of evidence, yet the belief in a link persists.

In a famous psychology text, *When Prophecy Fails*, the authors infiltrated a cult whose members believed that flying saucers would rescue them from an impending apocalyptic flood. When the date of the predicted catastrophe came and went, rather than abandon their belief, the cult members argued that it was only the strength of their faith that had averted disaster. This book inspired two researchers at Northwestern University, David Gal and Derek Rucker, to perform a series of experiments in which they shook people's confidence in a variety of their beliefs. Not only did no one abandon their opinions when presented with evidence, but those beliefs actually became strengthened.

The confirmation bias is evident in nearly every investment decision. Once an investor buys a stock, he/she tends to seek out information to corroborate their opinion that the stock will rise, while subconsciously ignoring contrary data. Consider the biotech company Amylin Pharmaceuticals, which together with partners Eli Lilly and Alkermes is working to bring to market a new diabetes drug called Bydureon. The drug is administered only once per week, marking a big improvement over the existing drug Byetta, which must be injected twice a day. On Monday, March 15, 2010, ABC News broke the story that the FDA asked for additional information on this potential blockbuster drug. Significantly, though, the partners were not asked to perform additional studies on the drug, but were merely asked for data concerning product labeling, manufacturing and risk mitigation. Analysts at Jefferies & Co and Barclays Capital immediately upgraded the stock. Amylin, which usually trades an average of 3.2 million shares daily, jumped 13% to nearly \$23/share on volume of nearly 30 million shares. Obviously people liked what they heard.

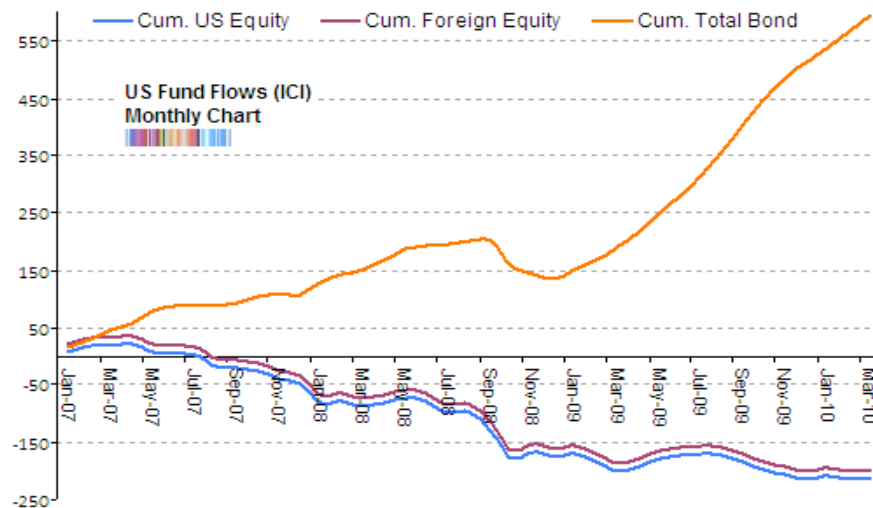
Over the next half year the stock generally traded above \$20. On October 14, Jim Cramer, the host of CNBC's *Mad Money* show, urged investors to buy Amylin in advance of the impending drug approval. Once again, volume spiked as investors heeded the advice. On October 19, though, the FDA rejected the drug, asking for additional clinical data. The stock plunged over 50% for the day.

Was there any data that, with the virtue of hindsight, might have given investors pause? Anyone familiar with drug development knows that there are always potential pitfalls. Of all drugs which make it to the final stage of the approval process, 40% never receive approval. Biotech companies, particularly, face even tougher hurdles than pharmaceutical companies in general, because they tend to be dependent on

only a few drugs. Since the end of 2007, 100 companies, fully 25% of all publicly traded biotechs, have ceased operations.

Then there is competition. Other companies are also working on potential diabetes treatments. In late September, Sanofi-Aventis reported improved control of blood sugar for patients taking its experimental drug lixisenaride. Finally, on July 28 Amylin stock plunged on speculation that the FDA was to call a meeting to discuss Bydureon in September, although management denied any such knowledge. All in all, while the odds did seem to favor approval, there were enough warning flags that a conservative investor should have been nervous valuing the company at \$3.5 billion despite the fact that it has never had a single profitable quarter.

This same phenomenon is glaringly evident when considering retail investors' current aversion to equities. Starting in 2007, when the financial system seemed to be on the verge of a meltdown, individual investors began a massive reallocation from stocks to bonds. The chart below shows

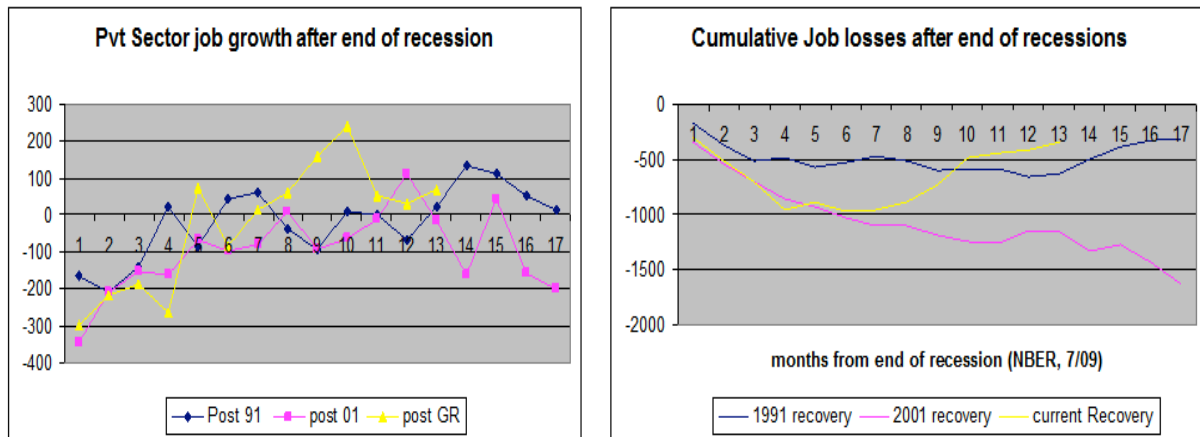


the cumulative flow in billions of dollars out of U.S. and foreign stock funds into bond funds, a reasonable proxy for the retail investor. While the graph shows data through March 2010, the trend has persisted through mid-December. The Investment Company Institute just reported 32 consecutive weeks of withdrawals from equity funds, with a cumulative \$96 billion being withdrawn in 2010.

Reasons for this risk aversion are certainly easy to find. While a double dip recession is a rare event (having occurred only three times in the last 150 years), it is by no means impossible. Unemployment is persistently high, staying over 9% for the past twenty months. Further, many of the employed are working at jobs with salaries far lower than they were used to. The rate of unemployed and underemployed is 17.3%. Wages for those working are only up 1% over the prior year. With consumer spending accounting for over two-thirds of GDP, weak consumer spending is a huge drag on the economy.

Housing accounts for 20% of GDP, and the prospects for home prices seem to get gloomier every day. Nearly three million homes were foreclosed upon in 2010. Post the expiration of the new home buyer credit, prospective purchasers disappeared, and the freeze on new foreclosures will probably prolong the pain of a weak housing market for months, if not years. The lawsuits filed by purchasers of mortgage backed securities will potentially force major banks to buy back over \$50 billion in underperforming securities, crimping their already reduced ability to make desperately needed loans.

At times like this, it is hard to be bullish. Or at least it is hard if you ignore the other side of the argument. Consider the two graphs shown below which show private sector job growth and cumulative job growth for thirteen months following each of the two previous recessions as well as the current Great



Recession. Given the political rhetoric concerning the need for a second round of stimulus, you would think that this data is classified Top Secret, even though it is freely available on the St. Louis Federal Reserve web sight. Job creation in the current recovery is actually somewhat higher than in the past two comparable periods.

In addition, stocks are cheap while bonds are expensive. At the same time that individuals are fleeing to the "safety" of bond funds, corporations from Duke Energy to McDonald's to Kimberly Clark are rushing to borrow at record low rates. The past summer saw the highest level of junk bond issuance in history. Who is more likely to be the smart money when retail investors are buying while corporate financial officers are selling debt?

The stock market is still down more than 20% from its peak in the fall of 2007. At the same time corporate earnings have risen dramatically, and the companies in the S&P 500 are forecast to have record operating earnings next year. Mergers and acquisition activity, dividends and share repurchases are all rising, and the stocks of many blue chip companies such as DuPont, Verizon and Johnson & Johnson have higher dividend yields than bond yields. At current rates it would take 500 years to double your money in a money market fund. Don't you think that a well-chosen stock portfolio will do better than that?

How then should we deal with confirmation bias, which appears to be hard-wired? First, develop the habit of looking for counterarguments for beliefs. Even if the other side does not seem persuasive, try to assign a probability to your belief. For example, if you were considering an investment in Amylin, acknowledge that there is a 60% probability that Bydureon will be approved, which is the same as saying that there is a 40% chance it will not. Second, do not surround yourself with yes-men. Listen to the arguments of smart people who hold an opinion contrary to your own. Most importantly, ask yourself whether you are considering all of the evidence, or are simply cherry-picking those facts which confirm your belief.