

KNOWN AND UNKNOWN

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INTRODUCTION

Until last month, 2014 was a year of investor complacency. Recent market volatility has shaken off the prevailing calm with a healthy re-examination of things that can go wrong for the economy. For investors, a long-term perspective is critical. Below we present some thoughts on these themes.

“There are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns - the ones we don’t know we don’t know.”

- Donald Rumsfeld, US Secretary of Defense, February 2002

CONTEXT

Donald Rumsfeld uttered the above quote during a Department of Defense press conference about weapons of mass destruction in Iraq. The result was ridicule from the media and the general public as to the confused if not unintelligible nature of the comment. It was considered a gaffe. Though often still highlighted by those denigrating the Iraq and Afghanistan war policy of the Bush Administration, the quote has gained respect over the years, and is now considered by many to be quite prophetic.



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I would postulate that unwittingly, Rumsfeld has given investors a helpful way to categorize the effect of exogenous events on financial markets. A good CEO of a corporation is judged not only on his/her leadership performance in the simple “blocking and tackling” of running the business, but also in their ability to react to unforeseen events...the “Unknown.” Rumsfeld’s comments suggest the division of leadership problems into three distinct categories; the “Known Known,” the “Known Unknown” and the “Unknown Unknown.”

Let’s use a hypothetical example to help identify the categories. The CEO of Big Foods, the largest food company in North America, might divide factors affecting his/her business as follows:

Known Knowns: Labor will want raises. Shareholders will expect growth in earnings, dividends and the stock price. Equipment will need to be replaced. Interest and principal on debt must be paid.

Known Unknowns: Cost of wheat, corn, etc. will fluctuate due to weather, diesel fuel prices, seed cost, blight, etc. Food tastes may change over time.

Unknown Unknowns: Discovering that XYZ, used for years to fertilize crops, causes cancer.

As you can imagine, for the CEO of Big Foods, it's the Unknown Unknowns that can put them out of business. These are the events that will test his/her leadership mettle. The goal of the CEO, when hit with an Unknown Unknown, is to take quick effective action, moving the Unknown Unknown to a lesser classification. Depending on his/her leadership skills, the crisis will determine if the CEO is viewed as a witless manager, or an effective crisis leader. The fate of the company, or at least the stock price, weighs in the balance.

Factors affecting the financial markets may be equally divided. Though certainly subject to interpretation, here are some classification examples as I see them.

Known Knowns: Inflation is a way of life – the cost of goods and services will rise over time. Lifespans are increasing. People's desire to improve life for themselves and their families makes capitalism the winning political system.

Known Unknowns: The rate of inflation (or even periods of deflation). Tornados, tsunamis, hurricanes and earthquakes. Global political instability. Next year's return in global markets.

Unknown Unknowns: 9/11. Unrecognized excess leverage (The Crash of 1929 and the Financial Crisis of 2007-08). Irrational exuberance (The Crash of 1987 and the Internet Bubble of 2000). **Pandemic.**

It is the Unknown Unknowns that may create the environment for market crashes and severe corrections. For example, the coordinated attacks orchestrated by Al Qaeda on September 11, 2001 shocked the world in general and the US in specific. It affected air travel and public safety concerns in a material way. 9/11 likely extended the bear market related to the popping of the Internet Bubble in 2000. The S&P 500 was down 9.0% in 2000, down 11.9% in 2001 and down 22.0% in 2002.

Unknown Unknowns, if addressed quickly and effectively, can be downgraded. In short, they can move to a Known Unknown, or even a Known Known. Using the 9/11 example again, airplane travelers now take for granted that they will need to walk through detectors, have their luggage opened and that air marshals with loaded weapons may be on their plane. In fact, many of us like it. Pre-boarding security is now a Known Known...a way of life. Airline profits have never been higher.



E BOLA – THE FEAR OF PANDEMIC, AN UNKNOWN UNKNOWN

At a time where the stock market had not had a correction of 10% or more since 2011, where investors were already absorbing (and downgrading) two prior Unknown Unknowns (Ukraine and ISIS), along comes Ebola. For US investors, Ukraine and ISIS, though troubling, are happening “over there.” Pandemic, however, can happen everywhere. It's unintentional medical terrorism. With the fear of Global Pandemic fueled by international air travel, consumers (and investors) are in a mini-panic. The price of oil has plummeted. Hotel and airline stocks have sold off precipitously. Biotech stocks working

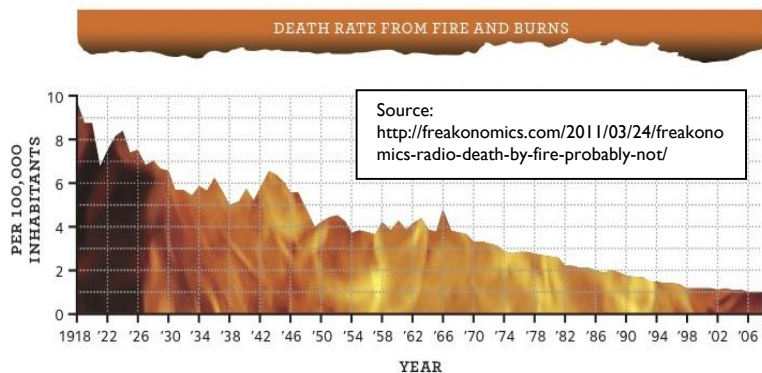
on an Ebola treatment have skyrocketed. Airline passengers with the sniffles are sparking quarantines, and [news of an infected nurse on plane can cause the stock market to nosedive](#).

What is troubling about the Ebola crisis is that it didn't have to happen. One would think that the world would be more aware of the international implications of infectious disease after the AIDS crisis. However, we continue to be reactive, not proactive. Complacency has been the genesis of this Unknown Unknown.

E BOLA – THE SILVER LINING?

Though we are overwhelmed with images of the Ebola crisis, there is a silver lining. Perhaps it is Ebola that will alert the world to the global threat of Pandemic. Thankfully, Ebola is not highly communicable, as it requires the transmission of infected bodily fluids. This pales in comparison to the risk of a true airborne virus. It is highly unlikely that Ebola will become a true global crisis, but it is more likely that it will pull the world together to address the risk of Pandemic. We will indeed be more prepared in the future.

In the book “SuperFreakonomics,” written by Steven Levitt and Stephen Dubner in 2009, the authors discuss the precipitous drop in fire-related deaths in the US over the last century. They attribute this to a law mandating the installation of sprinklers, which was passed as result of the Triangle Waist Company Fire in New York City in 1911, where 146 people died.



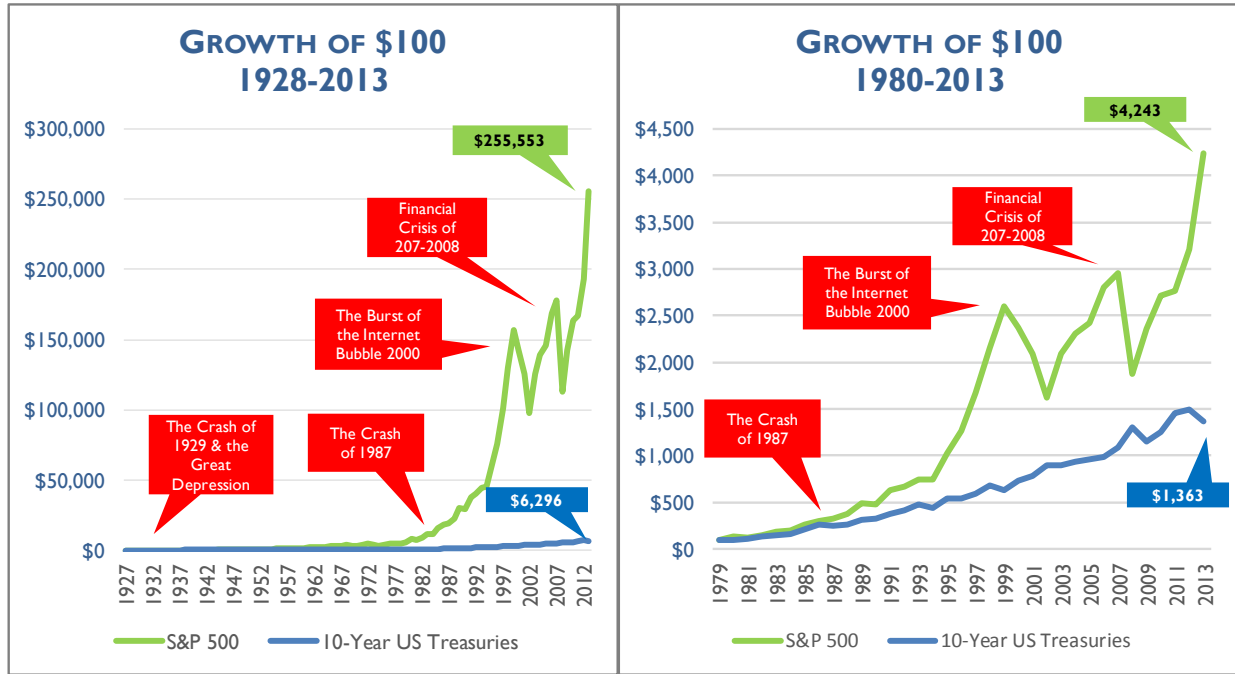
There is little political benefit to be gained in spending money on preventative measures until there is a public awareness of risk. If Ebola proves to be limited in its reach, the effect of raising global awareness of the risk of Pandemic could be of great value to society. In short, global preparedness for Pandemic is like the installation of sprinklers...preventative measures that are well worth the expense. If this occurs as I expect, we can cross Pandemic off our list of Unknown Unknowns.

T HE LONG TERM GROWTH OF EQUITIES - A “KNOWN KNOWN?”

The exceptional performance of equity markets over a long period of time has been unquestionable. When analyzing charts of the long-term compounded growth of capital invested in equities, it is often even hard to identify the panics and crashes, much less the corrections. In addition, the outperformance of equities relative to conservative fixed income over a long period of time is equally astounding.

Average Annual Return (Geometric)	S&P 500	3-month T.Bill	10-year T. Bond
1928-2013	9.55%	3.53%	4.93%
1964-2013	9.89%	5.07%	6.56%
2004-2013	7.34%	1.54%	4.27%

Source: <http://www.stern.nyu.edu/~adamodar/pc/datasets/histretSP.xls>

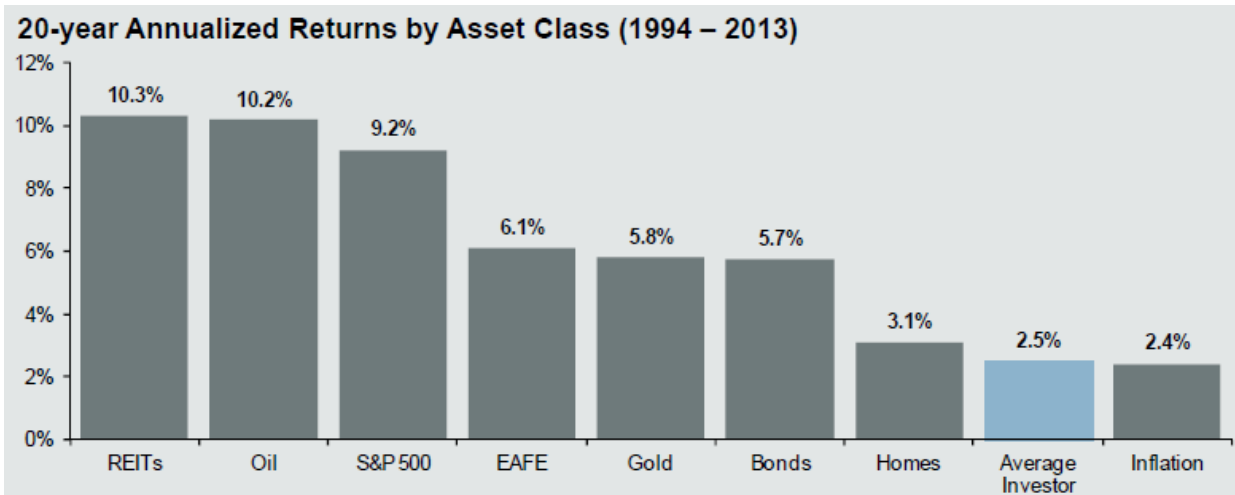


Source: <http://www.stern.nyu.edu/~adamodar/pc/datasets/histretSP.xls>

THE RETAIL INVESTOR – A VICTIM OF EMOTION

The above graphics clearly make the case for staying the course in equities. However, the average retail investor has not fared particularly well. This is due to their emotional and often panicked response to global events and market downturns.

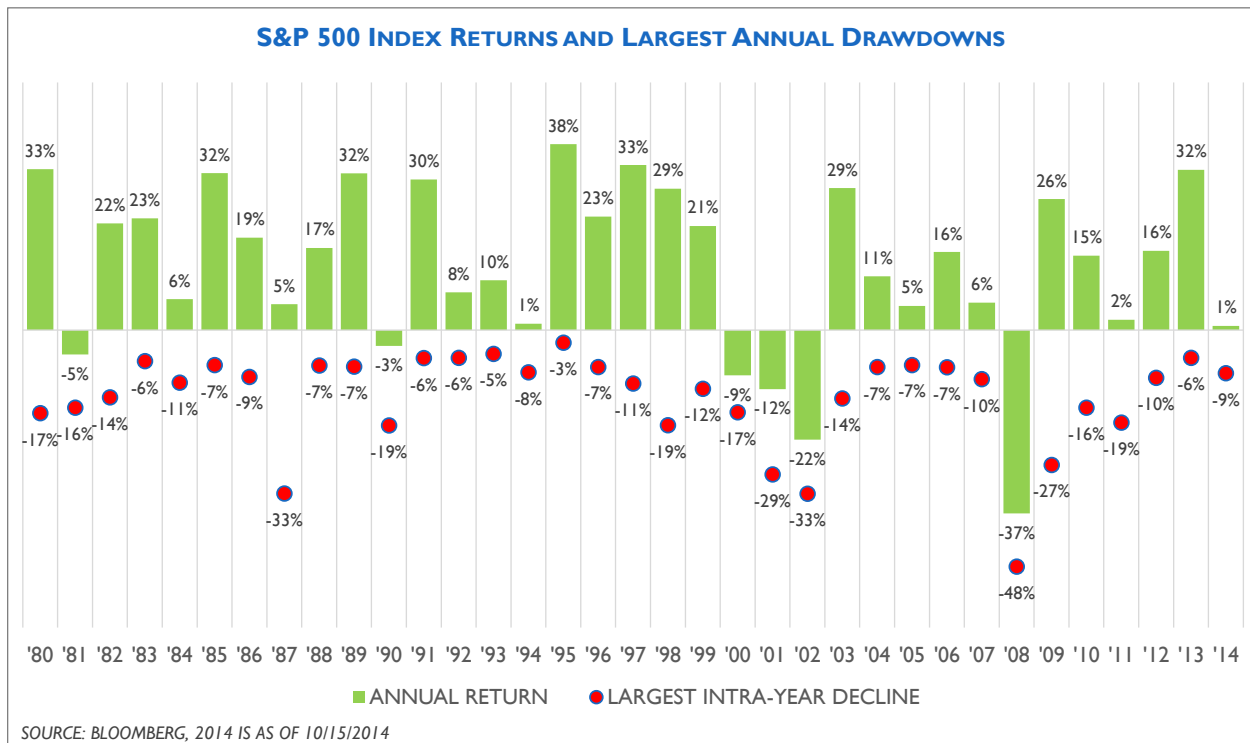
The investment performance of the retail investor is abysmal. **Retail investor sentiment is widely viewed by professional traders as a leading reverse indicator.** If retail investors are bullish, it's a sign that markets are topy. If they are bearish, it's usually time to buy.



SOURCE: JP MORGAN ASSET MANAGEMENT

CORRECTIONS AND CRASHES – HOW BIG AND HOW OFTEN?
Corrections are like pruning the vines and crashes are like replanting the vineyard. In either case, your grapes will grow back, and your wine will taste better. **Equity market corrections and crashes are a necessary evil.**

The graphic below shows that it is natural to experience a significant drawdown during what ends up being an excellent year for equities. It is also easy to understand why the retail investor can get scared out of the market.



CONCLUSION
Though we have more than our fair share of global concerns, **it is highly likely that Ebola is simply the catalyst for an overdue, healthy market correction.** As the Ebola crisis continues to run its course, and governments put significant resources into Pandemic response, Ebola will likely transition from an Unknown Unknown to a Known Known. A positive result of this crisis should be a higher level of global preparedness for Pandemic, perhaps moving the treatment of Pandemic out of the Unknown Unknown category forever

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