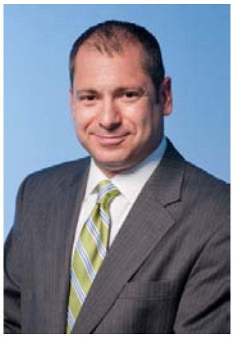

Written by Mitchell O. Goldberg
ClientFirst Strategy, Inc.
December 22, 2010
For immediate distribution

(This article appeared in the December 28, 2010 edition of The New York Real Estate Journal)

POP! This is the worst thing that can happen to investors.

You've heard that the worst things that can happen to investors are inflation, recessions, Fed tightening, and unfavorable changes to parts of the IRS tax code. These are all big potential concerns, to be sure. But the worst thing that can happen to investors is getting caught up in a bursting asset bubble. This is the worst…no argument. This applies to all asset classes; stocks, bonds, emerging markets, real estate, art, etc.

To start, stocks go up and down over the short term for many reasons, but the core tenet of investing is that over time, they will trend higher. But when they go down because an asset bubble popped, recovery is near impossible. And there it is…losses from asset bubbles are permanent for the overwhelming majority of investors.

Asset bubbles are so feared, as they should be, because they aren't apparent by watching the performance trend of the stocks you own or by the major averages. But is it even possible to spot an asset bubble before it bursts? Simply put, yes. **The answer lies in understanding the counter-trend behind the trend.** Think of the counter-trend like fuel for a fire; when you run out of fire wood, the fire dies, right?

A clear example is the tech bubble that popped in early 2000, which took the NASDAQ Composite Index down from 5,000 to 1,100. The obvious trend was that the tech stocks were flying high. But whether or not it was so glaringly obvious that they were stunningly overvalued wasn't easy to spot based just upon prices. After all, wasn't everyone eventually going to be on the internet? (It's hard to imagine that Google and Facebook weren't even around yet) The counter-trend, or fuel, was the over active IPO market; new tech company entrants had easy access to money. Once the IPO market started to cool in early 2000, the money supply for the industry (to purchase unlimited amounts of software and hardware) was cut off and the entire sector went into a rapid cycle of survival of the fittest.

Four things to tie this together:

1. Rising stock prices validates people's beliefs. Meaning, we feel smarter when our stocks go up. 2. Institutional money managers need to post performance figures comparable or better than their peers, so they chase performance, pushing stock prices up even more. 3. Recency takes over, which is the tendency of people to extrapolate what they see today into the future. 4. Complacency; investors stop doing their homework on their investments.

Simply put, behavioral science tells us that we feel smarter when our stocks go higher and that in turn reinforces our belief in our investing acumen. This is what makes investors vulnerable.

An abbreviated conclusion is that when you invest, you really need to understand that you are making 2 investments. First is the investment itself and second is the counter-trend that is fueling the investment.

The longer the counter-trend (fuel supply) is in place and the more ingrained it is in investor's assumptions, the bigger the bubble burst could be.

Today's trends have lots in common with trends of the past. Here are 2 potential bubbles to watch out for:

1. Treasury Securities: An environment of a week Dollar and low interest rates have been around for years now. I would consider these factors to be counter-trends. The trend has been a rise in Treasury securities prices. With the yield on the 10 year Treasury rising form 2.25% to a recent print of over 3.50% even with QE2, huge improvements in retail and automobile sales figures, and with the Dollar gaining strength against a basket of foreign currencies, it should remind anyone who reads this to pay attention…don't ignore the directional change in the counter-trends no matter how strong your belief is in the trend. A 30 year bull market in Treasury's looks to be at the cusp of a reversal.
2. Natural resources: This one is more controversial since price trends haven't shown any sign of reversing. The weak Dollar, currency debasement around the world, inflation concerns, and the demand for jewelry in emerging markets are counter trends that are totally legitimate at this time. But a lot of novice investors who haven't been burned by commodities are crowding the market. The real threat to commodities is when supply catches up to demand. Due to bone crushing drops in the price of gold, silver, oil, and other commodities in the '80's and '90's, mining companies either underinvested in new production or shut down mines altogether. This has left the world with supply constraints. Now mining companies are running full-out to increase mining productions, which is a slow process. This is the real counter trend that bears watching. But there has never

been a time in recorded history when production doesn’t eventually catch up with demand. So, watch the earnings reports from mining companies; that will be your “canary in the coal mine” early warning system.

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