

1st Quarter 2012

Applying Psychology to the Marketplace by Noel Bennett

Investing lies at the intersection of economics and psychology, the place where net present value meets greed and fear. It is important to know the numbers—but that is not sufficient. And it is important to know how people think—but that, too, is not enough.

Seth Klarman

In the past year many of us in the investment business had to admit that the forces moving the stock market were ultimately unknowable, which was frustrating because we are driven by our need to know. Would Greece default on its bonds and be forced to withdraw from the European Union? Was China's economy slowing too rapidly because it was based on an unsustainable real estate bubble, much like our own country five years ago? Would the U.S. economy behave as Japan's has in the last two decades and be immune to the Federal Reserve's ongoing stimulus attempts, slowly collapsing into a deflationary funk from which there will be no return for a generation or more? Nobody knew the answers. The predictable result even now in 2012 is that most people are behaving the way they always have in uncertain times: they look around at what everyone else is doing and follow the lead of those they believe have more and better information. The high net worth one percenters who are too busy to do their own financial analysis take the advice of people they respect and admire and who often have more at stake than they do. Mutual fund and hedge fund managers, most of whom long ago abandoned any pretense of being long-term investors, make their living trying to outwit the market in the short term, or at least attempting to act more quickly. They focus on the next month or the next quarter, knowing that their careers may be over if

they experience one or two very bad years. And the average householder continues to do what he has always done: buy high, sell low and wonder why he feels like he has been running in place for the past twelve years.

Nobel Prize-winning psychologist Daniel Kahneman has recently written a book, *Thinking, Fast and Slow*, that provides potentially valuable tools to help us break out of unproductive patterns of investing. According to Kahneman, most people are not as rational as they think they are, and even financially educated professionals consistently overrate their own abilities. He believes that our brains operate on two systems simultaneously, and that the fast, intuitive and automatic System 1 is far more influential than System 2, which consists of a slower, more rational and "more effortful" type of thought. It follows that our decision making is also governed by these two systems, and that includes the daily buy/sell actions that determine the course of the markets. Kahneman believes the all too human tendency to leap to conclusions using System 1 can be mitigated in several ways: first, use a team approach that intervenes "to limit the damage that bad judgments and choices can cause." Second, he advocates a general feeling of proper modesty about our abilities, and stresses the need to avoid overconfidence. And third, he advises that we be realistic about our ratio of investment successes to failures and admit we will always have a few losers along with our winners.

We strive to use all of these tactics at Peak and have since our inception. We also avoid what Kahneman calls an "optimism bias." Instead, we maintain a cautious concern for

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the serious problems plaguing both our own nation and foreign countries as well. We continue to have an opportunistic approach to investing, using careful bottom-up analysis to accumulate bargain-priced businesses; we also spend considerable effort on the important task of picking apart the behavioral biases that create both cheap stocks and overvalued ones.

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The article that follows was written by a financial planner for a magazine that is distributed to firms like ours. Even though its targeted audience is wealth advisors, we believe our clients and friends will find it to be interesting and helpful.

The Kids Are All Right (Maybe) By Scott Schutte

Unfortunately, we are not able to post Scott Schutte's article from *Financial Planning* online. Please call us at 1-800-298-9081 or send your

address to us via email at peakam@peakam.com if you'd like a copy of the newsletter with the article mailed to you.

Company Profile: PepsiCo by John McCorvie, CFA

The world used to be so simple: Coke or Pepsi? And then came "horizontal segmentation."¹

In a nut shell, horizontal segmentation is a democratization of taste. There is no best tasting soda. There is no best tasting potato chip. There are many people with many different tastes and if a company can identify a large enough group with a particular taste (large enough to contribute to profitability of the company), it should create a product to meet that taste. When I review the Pepsi products that I regularly enjoy, my own tastes range from the most basic to the more select: starting with Pepsi (fountain only), moving to Baked Ruffles (Original) and then to Gatorade Rain (Berry Flavor). One of the best measures I know of a company's success in horizontal segmentation and in the food business in general is the amount of shelf space its products occupy in a grocery store. A large amount of shelf space means it is able to take full advantage of horizontal segmentation's customer satisfaction and profitability, reinforce its brands through visual dominance and, importantly, leave less

space for the competition. And one of the obvious winners, if you have ever walked down the soda or snack food aisles, is PepsiCo.

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PepsiCo, Inc. was formed in 1965. Here is a brief history of its origin from the company's website:

PepsiCo, Inc. was founded by Donald M. Kendall, President and Chief Executive Officer of Pepsi-Cola and Herman W. Lay, Chairman and Chief Executive Officer of Frito-Lay, through the merger of the two companies. Pepsi-Cola was created in the late 1890s by Caleb Bradham, a New Bern, N.C. pharmacist. Frito-Lay, Inc. was formed by the 1961 merger of the Frito Company, founded by Elmer Doolin in 1932, and the H. W. Lay Company, founded by Herman W. Lay, also in 1932.

PepsiCo's four major business segments are: Frito-Lay North America (contributing 35% of sales and 47% of operating profits in 2010),

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PepsiCo Beverages of North America (35% and 29%), Quaker Foods (3% and 6%) and PepsiCo Int'l (snacks and beverages combined, 27% and 18%). Brands include: Pepsi, Sierra Mist, Izze, Tropicana, Ocean Spray, SoBe, Aquifina, Lay's, Ruffles, Fritos, Cheetos, Doritos, Tostitos, Gatorade, Propel, Tropicana, Naked Juice, Quaker and Rice-A-Roni (to name a few!).

We long ago identified Pepsi as a stellar business that we would like to purchase at the right valuation, and waited patiently for the stock price of PepsiCo to reach a level where we believe there is a comfortable margin of safety in purchasing its future stream of free cash flows (Pepsi's stock is currently trading just below a 15 price-to-earnings multiple). Like many other businesses that we have added to our Model Portfolio* over the years, PepsiCo is a dominant business that has an impressive track record of growing revenues, cash flows, earnings and dividends, while maintaining sound balance sheet management. We believe that the short-term negatives that have contributed to the lower stock valuation (including

some perceived management missteps and commodity pricing pressures) do not impact the long-term value of the business. With a solid 3.4% dividend yield paying investors to own it now, and international opportunities to drive near double digit earnings growth for years to come, we believe that PepsiCo's stock is an attractive addition.

**The Model Portfolio is not a real cash portfolio. It represents the core direction of our portfolio management strategies. Individual client portfolios are managed in accordance with the clients' specific investment objectives and constraints. Historical results are available upon request.*

¹ For an entertaining exploration of the origins of horizontal segmentation, see Malcolm Gladwell's (the insightful pop observer and author of *Outliers*, *Tipping Point* and *Blink*) talk on Howard Moskowitz's work in the food industry at http://www.ted.com/talks/malcolm_gladwell_on_spaghetti_sauce.html.

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