

The One-Sided Fallacy

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He who knows only his own side of the case knows little. His reasons may be good, and no one may have been able to refute them. But if he is equally unable to refute the reasons on the opposite side, if he does not so much as know what they are, he has no ground for preferring either opinion.”

John Stuart Mill, British philosopher from his classic *On Liberty*, 1859

What John Stuart Mill describes here is a logical fallacy that is referred to as *confirmation bias* in behavioral finance, and as *special pleading* by logicians. Simply put, this “condition” is a “one-sided fallacy” in which only supporting reasons for a thesis are presented, while opposing rationales are omitted. One-sided arguments are often used to persuade an audience toward a particular point of view – to “sell” an opinion, rather than providing both sides of the argument and thus enabling the audience to make an informed decision to “buy.”

The current tenor of political debate has been all about amplifying one-sided arguments as each party attempts to sell their view to voters. The same polarization has become evident in approaches to investment, and market bears these days are exhibiting all the classic symptoms of confirmation bias. Traumatic memories of the financial market meltdown and the ongoing economic uncertainty since have created conditions ideal for selling one-sided opinions. Committed market bears have ratcheted up their rhetoric to resonate with negative headlines warning of a double-dip recession or stock market decline. The financial media happily facilitates such opinion “selling” because it provides lively and sharp debate – high on entertainment value, but questionable on providing balanced perspective.

But we know better than to let these slanted arguments sway our market convictions. As I will explain, there are plenty of reasons to remain invested in equities.

Is the investor being “sold”?

Just because an argument is one-sided does not necessarily mean that the point-of-view being advanced is wrong, but it is almost always incomplete. Today’s headlines are obsessed with doomsday predictions. All we hear about is the economy falling back to near-recessionary conditions, unemployment remaining high, and the U.S. housing market continuing to be weak.



Presenting plausible scenarios for how economic or financial markets can deteriorate is certainly necessary, but not if those scenarios tell only one side of the story. For example, U.S. households have reduced debt and increased savings to their highest levels since 1992. Federal Reserve statistics show that household income devoted to debt service has dropped from 14.0% to 12.5%, its lowest level since 2000. A one-sided argument would paint this as the reason for the depressed current spending and a major reason behind the stalled economic recovery. To complete the argument, however, one must also acknowledge the counterpoint that repaired household balance sheets can lead to sustained increased spending in the future.

Consider another example: U.S. housing starts have fallen to an annualized rate of 500,000. On the surface, this might sound like another negative indicator, but what is often overlooked is the fact that with 1.5 million new household formations annually, the forces that inevitably absorb the oversupply of housing and firm prices are inextricably at work.

Since the Great Depression, there have been eight recessions. Each time, the potential for a double-dip recession was discussed ad nauseam. However, barring exogenous shocks, the economy has taken its natural course and moved forward driven by population growth, productivity gains, pent-up spending, and improving confidence. While challenges to recovery exist, like they almost always have in the past, economic and political focus will move toward correcting imbalances, reversing unpopular policies, and promoting business activity.

One could argue that the prevalence of one-sided arguments has made investor decision-making one-sided as well – as reflected in their overwhelming preference for debt securities (i.e., bonds) over equities. Since the equity markets *bottomed* in March 2009, \$42 billion has flowed *out* of equity funds while \$450 billion flowed *into* bond funds. According to Morningstar, an astounding \$52 billion (16% of all taxable bond flows) was invested in the PIMCO Total Return Fund in the last 12 months, making it the largest open-end bond mutual fund and almost twice as big as the largest equity fund. Year-to-date, the issuance of high-yield bonds is more than 10 times the equity raised in IPOs. The desire for safety and fear of deflation has reached the point that investors are willing to buy five-year Treasury Inflation Protected Securities (TIPS) with 0% yield. On the corporate front, investors snapped-up an IBM three-year note at 1% while the company's well-covered and growing common stock was providing a dividend yield in excess of 2%.

The argument that aversion to equities is attributable to poor fundamentals and growth prospects ignores compelling data on corporate profitability. According to Blackrock, corporate profits as a percent of GDP are near 40-year highs. Cash flows from improving profitability have increased corporate liquid assets to over \$1.8 trillion through the first quarter of this year and represent 7% of all corporate assets – a 37-year high. Operating earnings for the S&P 500 have improved 75% from their low. The sizable liquidity has increased merger and acquisition activity, business capital spending, share repurchases,



and to a lesser degree, stock dividends. In terms of valuation, the spread between S&P earnings and 10-year Treasury bonds has reached its widest point since 1980.

How and what to “buy”

Balancing both sides of an argument rarely leads to bold opinions that “sell” a particular point of view. In terms of investment perspective, a balanced view will contribute far more insight for achieving long-term financial goals. Unfortunately, bold opinions seem to resonate most to extend, rather than counter, overly bullish or bearish sentiment. Investors should be wary of being “sold” bold opinions of impending doom or great riches. Instead, they should “buy” an investment path dictated by sound investment principles, an appropriate time horizon, and a portfolio strategy.

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