8 Qualities Held by 'Second-Level' Thinkers

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True or false: The capacity to borrow today brings consumption forward from tomorrow?

The world is awash with more than US$220 trillion of debt. This is a whole lot of future consumption that's already been consumed.

Now we have to pay for it.

To make servicing this **historically high** level of debt a little easier, central banks have taken interest rates to **historically low** levels. You have to marvel at the symmetry (and stupidity) of this equation.

For all their PhDs and academic models, central bankers are pig ignorant.

How else can you explain their actions?

They have wilfully persisted with an economic model that is entirely and utterly dependent upon debt-funded consumption to produce growth.

Surely there's a limit on how much consumption can be transported from the future into the present.

Surely there's a limit on how much debt — irrespective of cheap interest rates — households can burden themselves with.

Surely there's a limit on how much debt this world can service before we trigger another (and more catastrophic) debt crisis.

Surely you'd think central bankers have asked themselves these most basic of questions.

Obviously not. Otherwise they wouldn't be doing what they are doing…taking us long into a Greater Depression.

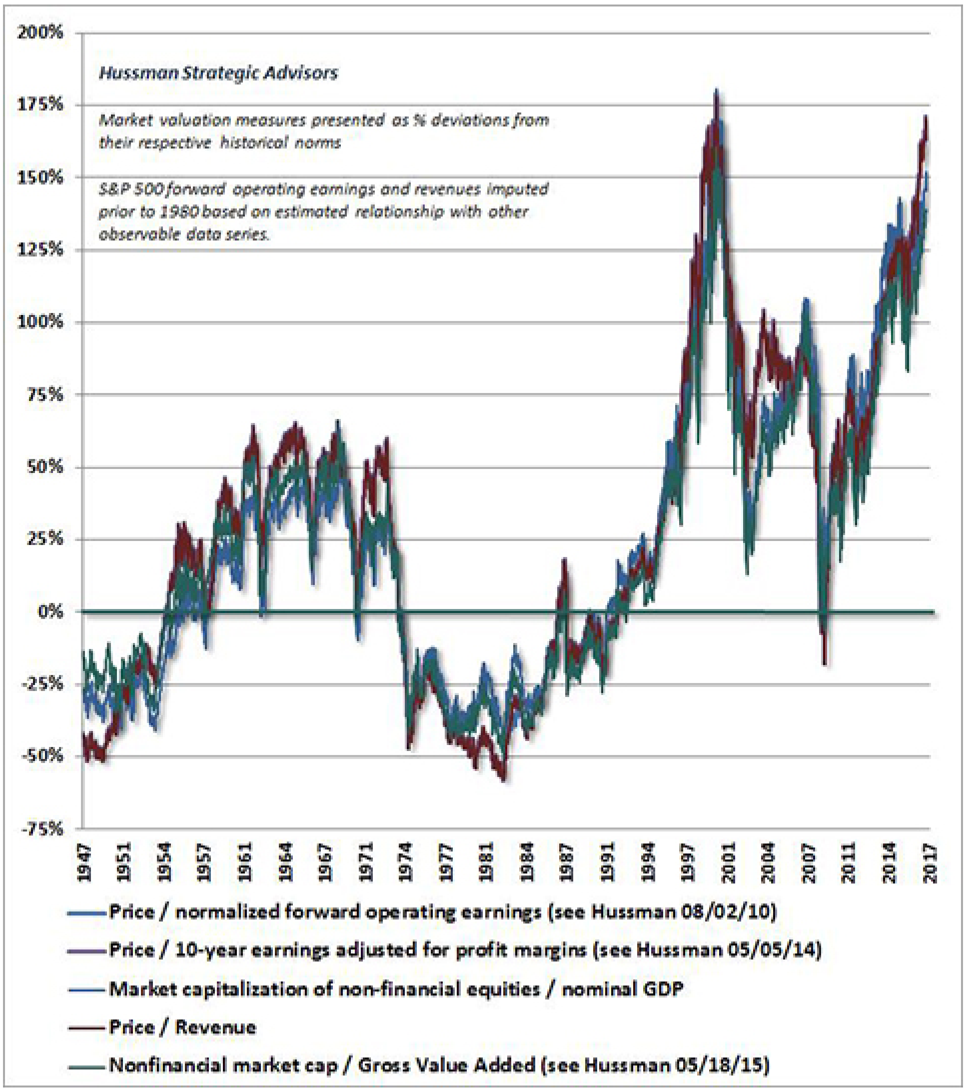
The central bankers' strength — academic prowess — is actually their greatest weakness. With formulas to formulate, theories to theorise over, and academic papers to write, there's no time for the basics. Simple questions like 'can this continue?' are far too trivial for the economic elite.

So they remain ignorant to reality.

The following chart traces out five different market valuation measures on the S%26P 500 index since 1947.

The 0% line represents the 70-year fair-value average.

Note the market spends most of its time above or below the average. Alternating between under- and over-valued.



Source: Hussman Funds
[Click to enlarge]

Since 1990, the market has spent most of the time in overvalued territory. This coincides with the time the Fed — led by Alan Greenspan — began putting their fingerprints all over the market…creating the so-called 'wealth effect'.

Prior to 1990, there was a rolling pattern in the movement between under- and over-valuation.

After 1990, the peaks and troughs take on a more jagged appearance.

It's beyond me how the Fed can remain so ignorant to the whipsaw effect its intervention has had on the market. But here we are again…sitting atop another jagged peak.

A sharp fall back to the 0% line requires a correction of 65%. But who's to say the market will stop conveniently at the long-term average. Perhaps the coming market collapse could revisit the lows of the early 1980s? Should this happen, we'll see the US market fall over 80% in value.

Historical precedent means losses of this magnitude cannot be ignored or dismissed as impossible.

Knowing your ignorance is a strength, not a weakness. It makes you ask questions.

In my latest book — *How Much Bull Can Investors Bear?* — I devote a chapter to 'knowing your ignorance'. This is an edited version:

Chapter 10
Know Your Ignorance

'*Real knowledge is to know the extent of one's ignorance.*'

Confucius

'*Being ignorant of your ignorance is fatal in the world of investing. You'll find yourself taking on far more risk than you should.*

'It was Warren Buffett who said "Risk comes from not knowing what you're doing."

'*I recall being asked at a social function about the level of volatility in the share market. My distilled response was,* "The market is reacting to the prospect of deflation and there's a better than even chance we will have a depression."

'*A lovely lady in the group then asked me,* "Is it better to have debt in that situation?"

'*I have to admit I wasn't expecting that one.*

'*A little later we spoke privately and she said that she and her partner were considering borrowing to buy a home. Again, I wasn't expecting that, either. They're in their mid-50s and I assumed they owned their own home.*

'*Long story short — she lost her first home (with her ex-husband) in the 1987 share market crash. She lost her second home (with her current partner) in the dotcom bust. In both cases, the home was used as security for loans taken out to invest in speculative shares…at the top of the market.*

'*Financial ignorance led her to take risks she was ill-prepared for. These poorly thought–out decisions have cost her dearly. Consequently, at a stage in life when you should own (or substantially own) your home, there is no asset base to speak of.*

'*I'm a firm believer that our lives are a sum total of the choices we have made. Obviously, there can be exceptions to this rule, but by and large we end up where we are because of the decisions we make in our lives.*

'*If you choose to eat fatty food, smoke and drink heavily, then you can hardly complain about having poor health. If you marry a liar, womaniser and gambler, then there's a fair chance you'll end up broke and divorced.*

'*Based on this simple principle, my goal has been to educate my family to make informed choices when it comes to their lives and finances. Knowing that you cannot know everything is a strength — not a weakness.*

'*My first book,* A Parent's Gift of Knowledge*, was a practical way for me to impart to my daughters some of what I've learned from life and the investment business. The book was an introduction to investing and a future reference guide for some old fashioned basic principles.*

'*Their education must continue — which was partly my motivation for writing* The End of Australia *and now this book — otherwise they run the risk of being ignorant.*

'*One of the books I've recommended they read is* The Most Important Thing: Uncommon Sense for the Thoughtful Investor.

'*The author, Howard Marks, is the multi-billionaire chairman and co-founder of Oaktree Capital Management — the world's largest distressed-debt investment firm. Marks wrote the book in 2011.*

'*This extract is one I've emphasised on numerous occasions during our family discussions (emphasis mine):*

> 'For your performance to diverge from the norm, your expectations — and thus your portfolio — have to diverge from the norm, and you have to be more right than the consensus. **Different and better: that's a pretty good deion of second-level thinking**.'

'*This is another way of saying "when everyone is thinking the same, it shows no one is thinking at all".*

'*To be a successful investor you have to think differently to the crowd. Marks says the crowd applies "first-level thinking".*

Comments like:

'You can't go wrong buying (whatever the latest hot investment is),' and, 'The market has lost so much value it is just too risky to buy now.'

Whereas "second-level thinking" would form these conclusions:

1. *'If everyone thinks you can't go wrong buying XYZ, then surely this is the greatest time for things to go wrong.'*
2. *'If the market has fallen so significantly, then it should be less risky than it was at its peak.'*

According to Marks:

'Second-level thinking is deep, complex and convoluted. The second-level thinker takes many things into account:

1. What is the range of likely future outcomes?
2. Which outcome do I think will occur?
3. What's the probability I'm right?
4. What does the consensus think?
5. How does my expectation differ from the consensus?
6. How does the current price for the asset comport with the consensus view of the future, and with mine?
7. Is the consensus psychology that's incorporated in the price too bullish or bearish?
8. What will happen to the asset's price if the consensus turns out to be right, and what if I'm right?'

'*The [investment industry] is full of "first-level" thinkers — perpetuating myths (more on these in the next chapter) to sell products . Never really questioning the orthodox economic commentary provided by economists in the employ of institutions or analysts' recommendations.*

'*You have to educate yourself to be a second-level thinker — even if you only partially do this, you'll be a of the majority of the planning community.*

'*The lovely lady I met is, even after her previous experiences, still a first-level thinker. Unfortunately, she'll continuously make bad financial choices because there's no critical thought applied to her decisions. But she is far from alone.*

'*I can tell you from experience that most people are first-level thinkers.*

Unfortunately, those charged with our economic stewardship are not second-level thinkers.

They're blindly obsessed with their economic models. And, when these don't work, it's not because the model was flawed, it's because not enough stimulus was provided. The old 'more fatty foods are needed to cure obesity' mindset.

Please, I implore you, for the sake of your financial well-being: Be a second-level thinker.

The Gowdie Letter takes a deeper look at the issues that can adversely impact your wealth. Sadly, most people fail to see the risks building within the global financial system. When the risks reveal themselves, it'll be too late.

Forewarned is forearmed.

Vern Gowdie,
For *Markets %26 Money*