MRP CAPITAL INVESTMENTS, LLC

Reflexivity

Research Report 5/13//2013

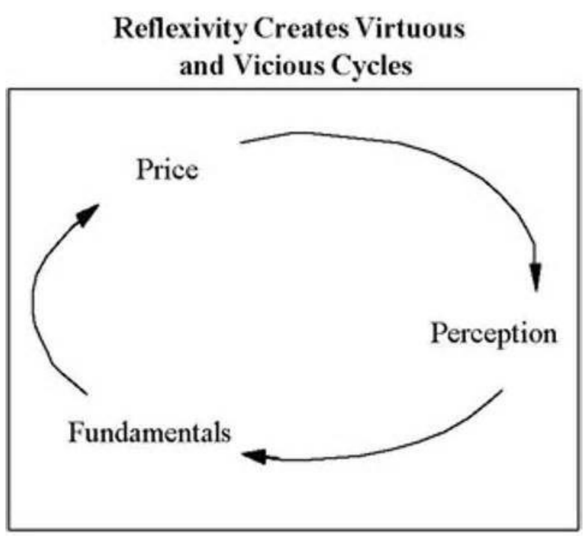
Introduction

Inside this report:

The other day, I'm having a conversation with a group of savvy and active investors and the topic of "What are you buying now?" comes up. I mentioned I liked insurance companies. It was then brought up from our past conversations that I bought shares of a specific life insurance company less than a year ago that had appreciated over 30%. A few days later I got an email from one of the gentlemen that was in the aforementioned conversation. In that email he said, "Yeah, that thing might really begin to take off when they start buying back stock."

Frankly, I think he was spot on and absolutely correct regarding this statement. However, I'd never considered that. I just thought the stock was really cheap when I began buying it. Nevertheless, right then and there it hits me like a brick…

REFLEXIVITY!!!!!!!!!!!!!

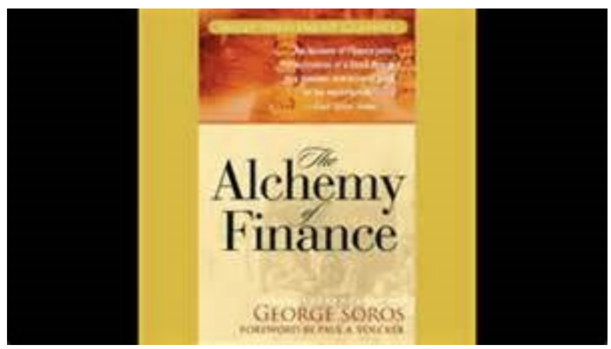


Background

Okay...most people are probably saying, **"What the heck is Reflexivity?"**

Here is some background on it:

I first heard about The Theory of Reflexivity while reading George Soros' book "The Alchemy of Finance." Soros' concept of reflexivity states that the biases of individuals enter into market transactions, potentially changing the fundamentals of the economy. Soros argues that such transitions in the fundamentals of the economy are typically marked by disequilibrium rather than equilibrium, and that the conventional economic theory of the market (the efficient market hypothesis) does not apply in these situations.



Reflexivity is based on three main ideas:

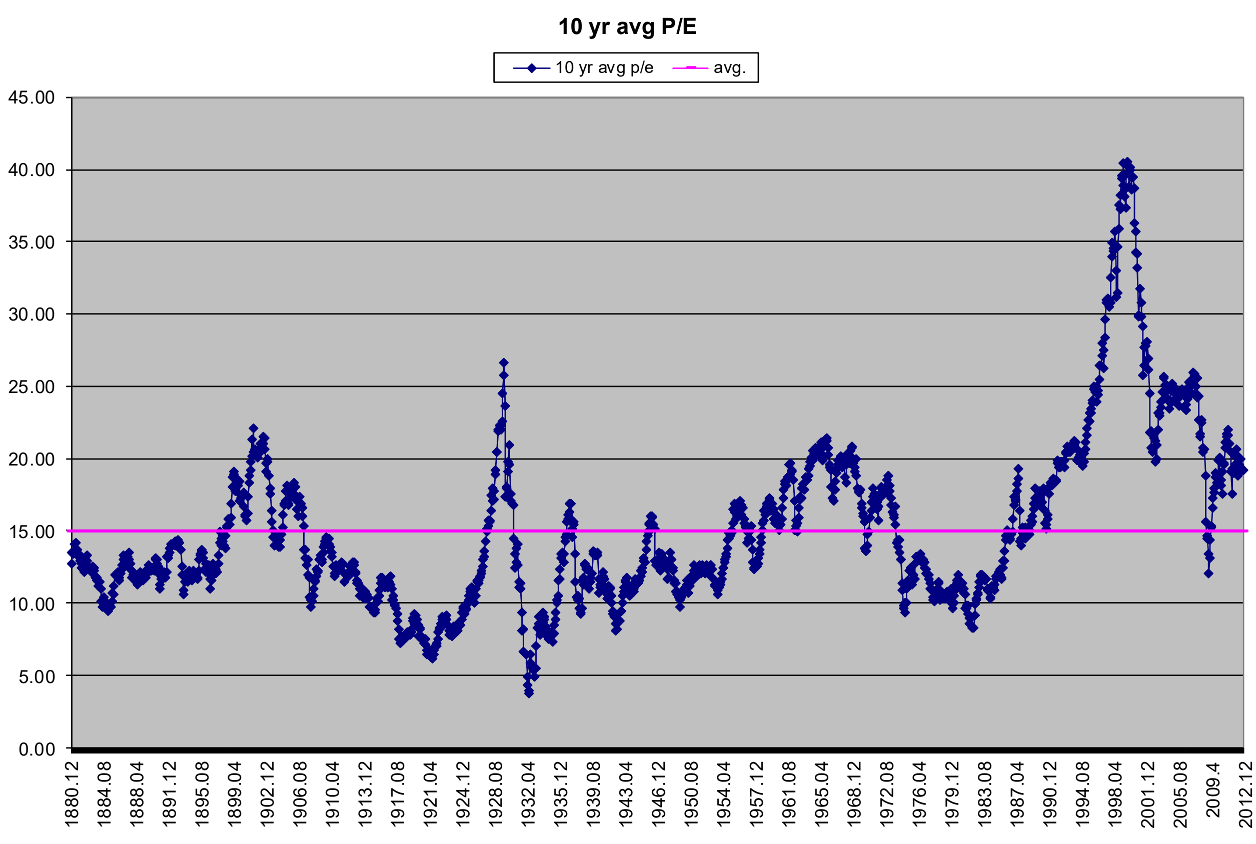
1) Reflexivity is best observed under special conditions where investor bias grows and spreads throughout the investment arena. Examples of factors that may give rise to this bias include (a) equity leveraging or (b) the trend-following habits of speculators.

2) Reflexivity appears intermittently since it is most likely to be revealed under certain conditions; i.e., the equilibrium process's character is best considered in terms of probabilities.

3) Investors' observation of and participation in the capital markets may at times influence valuations AND fundamental conditions or outcomes.

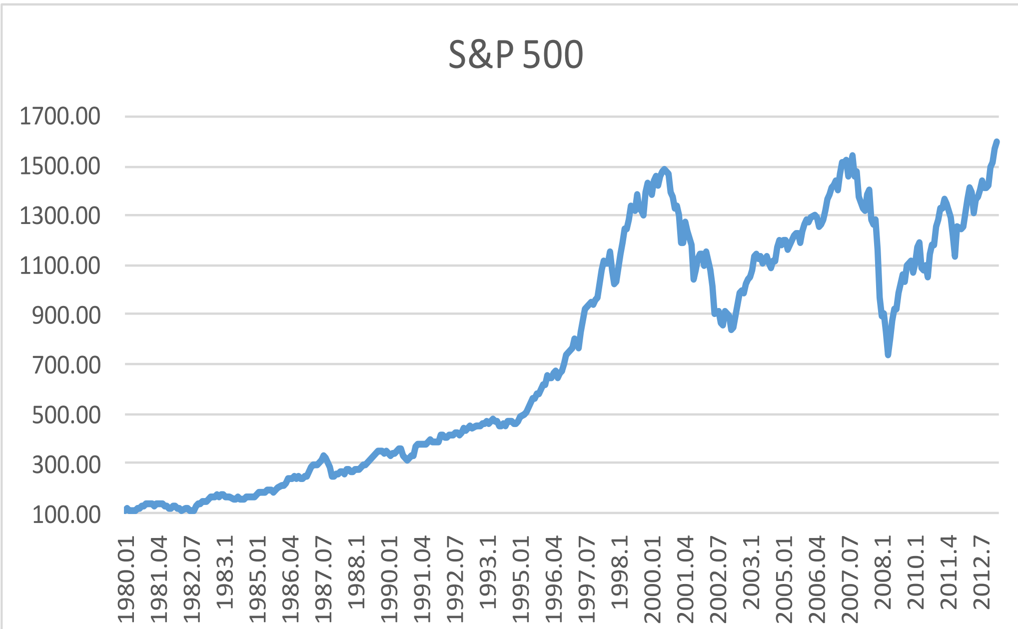
In basic terms, he is saying is that once a group of people start doing something in the market and they have success...others will pile in. This piling in directly affects that market place. For instance, if everyone likes company X and they are buying up that stock at any price...then company X can get cheap capital by issuing shares to the public at very attractive prices. This makes it so much easier for them to operate their business than it normally would and, therefore, easier to meet the expectations of the market and their investors. HOWEVER, at some point the people/investors will realize what they are doing and see how ridiculous their behavior has been. Then the whole thing unravels. And, in fact, the exact opposite can happen...sending the specific stock and/or a marketplace into complete disarray and tanking it beyond the level of rationality until they realize that they have been stupid again. And the whole thing starts again, this time to the upside.

You can see how this phenomena works by looking at many examples. Below is a chart of the 10 year average P/E Ratio of the S&P 500. Note the High P/E's investors are willing to pay during the Boom times of reflexivity (late 1920s, late 1960s, late 1990s) and the low valuation levels during Reflexive Busts (1930s, 1970s, and the 2000s).



Data provided by MRP Capital Investments, LLC database

Combining these valuation changes with the corresponding changes in earnings, these tweaks in the operating environments make for massive volatility in stock market prices.



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Past Examples

What is interesting to me is that everyone reading this has experienced the powers of a reflexive market, but they may not realize it. In fact, I'd make a strong argument that the tech rally of the late 1990s was a great example of a Reflexive Bull market. After a fundamentally driven beginning to the Bull Market in the 1980s, the market shifted into overdrive around 1995.

This turbo boost relative to the markets hit the "Up" button on asset prices and led Federal Reserve Chairman Allen Greenspan to make the following comments on December 5th, 1996.

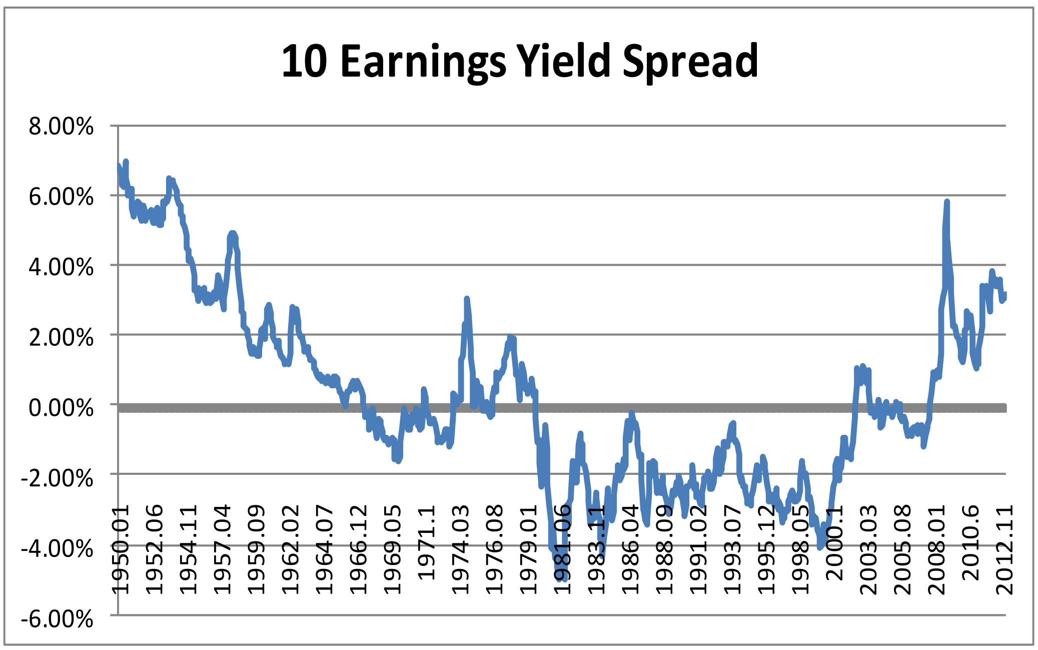
"But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade?"

What is crazy about that comment, which clearly suggested that the leader of our economy noticed that asset values were getting too high, is that the S&P 500 appreciated in excess of 100% from the time that statement was made until that market finally burst. This shows the power of reflexivity is ENORMOUS!!!

Of course when the P/E ratio on the Nasdaq broke 100 in 2000, everyone began to realize that their behavior was, indeed, irrational, and the markets tanked for 3 years. Only to see the irrationality shift to the housing/mortgage market, which was fun while it lasted. But that began to fall apart and pulled the entire world economy into a Reflexive Bust in 2008.

Thoughts on the Future

I believe that right now, we are getting close to the end of the "Rational" Bull Market. Early 2009 marked the end of an incredible panic, which is how Reflexive Busts typically end. You will note from the following chart that valuation levels on the S&P 500, when compared to the yield on the 10-year Treasury, were the most attractive they had been since the 1950s.



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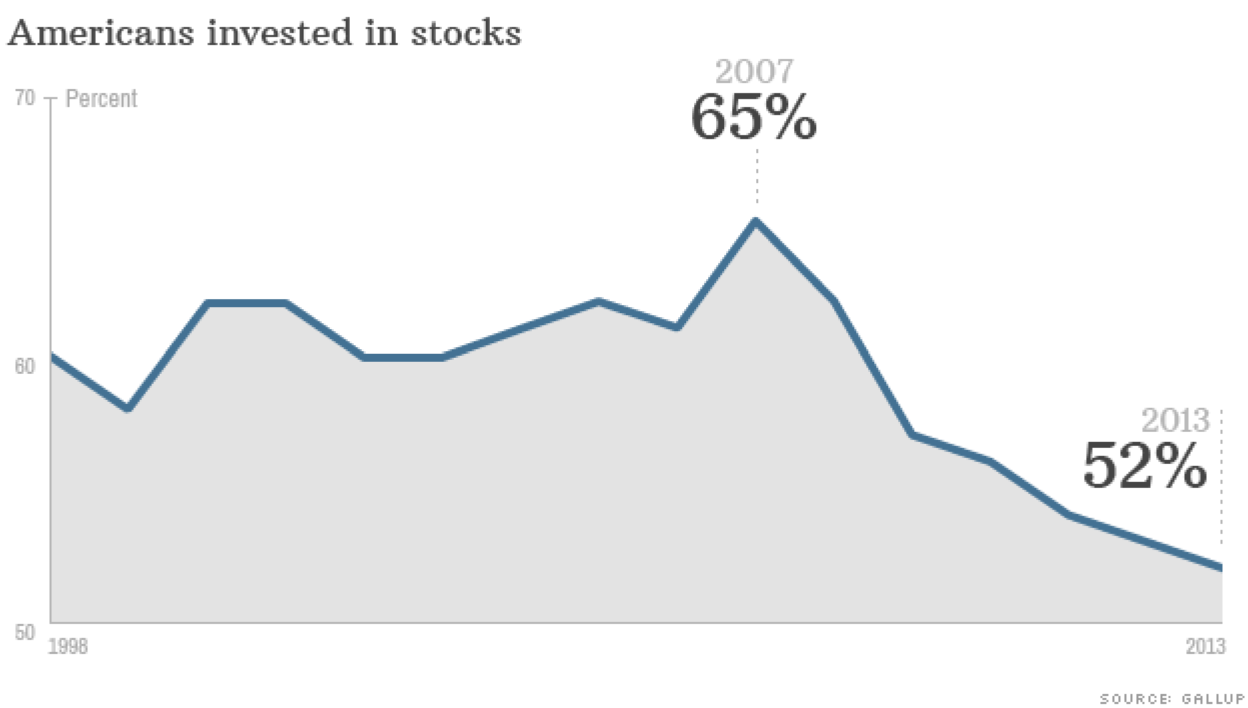
Applying basic logic, Bull Markets can begin when valuations are low. You've all heard the saying, "Buy low. Sell high." 2009 was a real world example of that mantra.

From the beginning of that market run, the S&P 500 has appreciated over 100%. Given the low valuations that were in the market when this Bull run was kicked off, I think it is fair to call that a fundamentally driven Bull Market. But the public at-large, still seems hesitant to believe this Bull Market is for real and they latch on to every pull back as a sign that this market is about to pop and sell off again. But to understand Bull Markets, you need to study them and know how they move. Since most people do not study markets, they missed the bulk of this run due to fear and hindsight investing.

In fact, a recent Gallup poll shows stock ownership among individuals is at an all-time low!! I mention this because Reflexivity can be akin to "piling on". In order to have an impact of people piling on, there must be ample people who are not already on the pile. It sure appears there are people standing on the sidelines who can join this dog-pile.



Bear in mind, Bull Markets do not move straight up. There will be significant pull backs on the path to profits. For details, please read my 3/24/2013 piece entitled "Understanding a Bull Market." But, nevertheless, savvy investors can use pull backs to buy stocks on the cheap and potentially improve portfolios.

Looking at the numbers, this fundamentally driven Bull Market has more room to run. However if reflexivity does kick-in, these rational limits on the market's upside could be proven moot.

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MRP CAPITAL INVESTMENTS, LLC

179 Lakeshore Shore Drive

Berkeley Lake, GA 30096

404-274-7851

www.mrpci.com