

April 2009: Concerning Politics

March's rally

We write this commentary on the heels of a big rally in the S&P500 off of the March 2nd lows and as a feeling of confidence is returning to investors. Much has transpired in the last month to push stock prices higher; however, we feel that January's and February's heavy selling and big market decline were probably overdone and short-sellers needed to take a beating.

We have no idea if this is a bear market rally, or if the March 2nd low will mark the bottom for this market cycle. For us to try to guess is a waste of time because such information is unknowable *ex ante*. We just continue to keep our eye on key developments, monitor the investments that we hold (that we believe are of good quality and priced way too cheaply) and continuously seek new opportunities – with the confidence that quality, underpriced assets will trade up to much higher values in the future.

Concerning politics

As investors, it is imperative to try to assess new government legislation, regulations, pronouncements and rule changes as well as their impact. The programs that cause us concern are those that promote short-term outcomes to satisfy populist desires (i.e., for real estate prices to go up and for the disgorgement of Wall Street executives), but have potentially destructive *long-term* consequences. In our view, this recent era of *ad hoc* rule changes is one of the reasons that risk aversion has become so prevalent – investors are simply not accustomed to having the government so involved in markets.

We rarely comment on the political environment because, as a firm, we try to restrict our interpretation to policies – not politics – and their impact on investors, irrespective of political ideology. We also realize that politics can be a sensitive and highly personal issue for many. That being said, it is important to try to evaluate whether policy proposals will benefit or harm our clients. Since the political climate has changed *so* immensely and new pronouncements are coming fast and furious, we thought it appropriate to share our take on the political climate and how it may impact investors.

Overreach of government jurisdiction?

The issue that sparked this month's commentary was the controversy over the \$165 million in bonuses recently paid to AIG executives. These contractual bonus payments caused so much uproar that a special tax was handily passed in the House to effectively disgorge bonus recipients of their money. These bonuses were provided under a contract that was entered into in good faith by both AIG and its executives (and of which Timothy Geithner was fully aware). The special targeted tax sought to annul these contracts, suggesting to us an overreach of government

jurisdiction. There may have been grounds if a) AIG was bankrupt or b) if AIG was an agent of the U.S. government. Neither was the case.

While this tax plays well to television cameras and speaks to citizens' outrage, actions such as this may ultimately undermine the rule of law in the United States. While we don't agree in concept with paying bonuses to executives of failed institutions, the sanctity of legal contracts must be preserved: both foreign and domestic investors may be wary of engaging in a market where contracts or private policies are subject to political whim. This is what keeps us up at night. Thankfully it looks like this bill is being delayed by the Senate and the Obama Administration has expressed its doubts.

GM and its auto industry brethren have also dominated newspaper headlines and government hearings. In our opinion, recent developments at GM are a step in the right direction. Major change is needed to reduce the capacity and legacy costs of this terrible business and any move to that end – whether it's bankruptcy or not – is the right move even it causes short-term dislocations.

Rick Wagoner being forced out is, in our view, a positive; however, we are concerned about how this came about as it appears that the Obama Administration called for his resignation. We are not questioning whether Wagoner deserved to be fired because, after all, GM's stock was at \$70/share when he was named CEO and it is \$2 today. What concerns us is the precedent. If capitalism is not allowed to function without politicians asserting their will, investors may be reluctant to finance what may be otherwise great businesses or great ideas for fear of future government involvement, either as a direct threat, or as a subsidy to the competition. Economic development will suffer as a result.

Actions influencing market positions

A related concern is the government's inclination to torpedo positions it deems contrary to public interest and, as such, many investors fear what the government's next "target" will be. Last year this occurred in the financial sector: one day you could short bank stocks, the next day you couldn't. These sudden rule changes resulted in many investors being punished for positions that made sense given the deterioration of bank balance sheets.

The recent tension with the Chinese also evidences this point. The U.S. government's attempt to try to undermine its own currency by printing money has alarmed Chinese officials. This is of the utmost importance to the Chinese as they hold huge amounts of dollar reserves: if the dollar declines vs. commodities and other currencies, it decreases the real value of their dollar-based position. The head of the Chinese central bank, Zhou Xiaochuan, in an uncharacteristically blunt statement said that the U.S. dollar needs to be replaced as the world's reserve currency. How and when this conflict with China resolves is anyone's guess; however, as China is one of our largest creditors, their concerns must be considered.

Finally, the Stimulus Plan

The final political development that has weighed on the market during the past few months is the Obama stimulus plan: a multi-trillion dollar collection of new programs and earmarks.

Larry Summers had, on several occasions during the election campaign (after he became Economic Advisor to Obama,) summed up what an appropriate stimulus package would look like: it would be “timely, targeted and temporary.” Investors assumed that meant Obama’s plan would focus on near-term job creation, with heavy emphasis on “shovel-ready” infrastructure programs that would, like Eisenhower’s Interstate Highway Program, stimulate the economy and open new areas up for economic development.

Instead, we received a plan for the *America of the next decade*, based on a vast expansion of the powers and costs of government *now*. Rahm Emanuel, Obama’s Chief of Staff, said in a very revealing comment on how politicians regard this downturn, “You never want a serious crisis to go to waste...This crisis provides the opportunity for us to do things that you could not do before.” Investors, anticipating measure that would have an immediate impact, were not prepared for enormous government expenditures on the long-term goals of health care, global warming, and education, especially given the challenging economic environment and the country’s weakened fiscal position. Stock markets plunged accordingly.

As an aside, we are keeping our fingers crossed that Obama will be able to rein in the trial lawyers and find a way to lower the litigation risks and costs that are the *real* reason why this country spends such egregious amounts on health care compared to the rest of the world. Since the trial bar is one of his biggest backers, we have our doubts whether he is prepared to push for actual reform.

To be fair, the stimulus program does include money for roads, bridges and other job-creators—but only around 5% of the total. As for the rest, House Democrats gave the nation an encyclopedia-sized monstrosity with spending programs budgeted at nearly \$800 billion. No Republicans voted for it, their resistance hardened by Republican and moderate voters expressing horror at “runaway spending.” According to various nonpartisan analysts, \$290 billion or more of the spending will not come before 2011.

According to Obama, “We cannot successfully address any of our problems without addressing all of them.” In the minds of investors, Obama has not lived up to his moderate advance billing, nor have his multi-trillion dollar “recovery” programs been focused on near-term job creation and tax reductions, as we—and most other investors—had expected.

For the investor class, however, one rescuer has demonstrated his credibility: Ben Bernanke. As he proved on March 18th, he can still unleash a magnificent market rally by telling what he’s doing, why it’s going to work, and why the recession should end later this year. Mr. Bernanke continues to display integrity and professionalism. His ingenuity and sense of history could well prove effective enough to offset any potential damage resulting from the House majority’s spending ambitions.

Conclusion: The Opportunity Set

There is a lot to be positive about and many incentives for the world to fix itself. The upside to all the government involvement is that they will print and throw a lot of money at the problems and eventually it will stick. They will not stop until the economy turns around.

In our view, the deflationary environment, which has already been significant with a \$30 trillion decline in global equity values and \$10 trillion in U.S. residential real estate, is largely behind us, but we're still in a period where credit markets aren't functioning properly. Deflation will probably not last as long as most people think. As such, we think it's highly unlikely that there will be a return to the Great Depression. During the Great Depression, there was a governmental reduction in liquidity; this time around we have a huge *creation* of liquidity. Eventually all the liquidity will bid up asset prices and fund legitimate businesses that create value to their customers and shareholders.

Finally, brilliant ideas and good businesses are getting financing (early indications are that the Rosetta Stone IPO in two weeks will be a hot deal), which would *not* be the case if we were in Depression-like conditions. *Speculations*, on the other hand, *are* having trouble getting financing, which is appropriate. There has been way too much speculation over the last 10+ years, so the capital that *is* available should be used to partner with businesses that actually contribute to economic development and improving living standards.

We have not changed our long-term view that this economic crisis will pass and that the best investments are those that enable ongoing global economic development. The credit crisis has caused much shuttering of production of what were already scarce resources, and the political winds will ensure that natural resources in the United States will be very difficult to develop. China will continue to grow and improve their living standards, governments will continue to add stimulus and print money, and economies will recover...all of which favor cyclical businesses and assets that hold their value vs. dollars and other currencies. 2009 will be a choppy year, but we are confident that, absent some unforeseen event, asset prices are cheap enough relative to their long-term worth, to take sensible positions and be patient.

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