

## **August 2011: A Moment of Clarity**

**By John Goltermann, CFA CPA**

Most people who own stocks do not enjoy big downside volatility days such as that of August 4. Unfortunately, days such as these happen occasionally as investment markets are subject to the emotional reactions of human-based survival mechanisms and the incentive-response systems that are part of our DNA. Big down days – though disconcerting – are to be expected from time to time.

The good news is that panic and dismay are not paradigms that last forever. People become exhausted by fear and, as such, their focus hones in on the very elements that are causing the fear in the first place. At that point, healthy discussions around identifying problems and proposing real solutions can begin.

In the present period, we attribute the current gloom to the growing realization that OECD governments are over-extended and don't have the resources needed to pay for everything they would like to pay for, and that the private sector is going to have to do most of the heavy lifting. For a long time, we have become conditioned to the government providing a stimulative response to adversity, whether it's fiscal stimulus by Congress or massive liquidity injections by the Fed. That paradigm has caused us to become complacent and unfocused and has created myriad structural imbalances, massive deficits and a deteriorating confidence that cheapening credit can no longer solve. Liquidity is not the solution. Structural reform, government reform and a competitive agenda are likely to be much more effective.

What politicians won't adjust voluntarily, markets will adjust by force. And market adjustments are much more painful and confidence-damaging. The current selling we see in investment markets is a typical risk-aversion response to U.S. and European politicians' bickering about how to address the effective collapse and unaffordability of the enormous social safety net that took seventy years to erect. An acknowledgement of the problem and a vigorous, healthy discussion of the tradeoffs of various solutions still lie in the future. Uncertainty over the path forward has brought risk aversion.

If one reduces the big issue to its essence, the current political debate is over who is going to bear the most pain in the structural rebalancing – those who were over-promised government benefits, or those who have capital and income. The political rhetoric has caused those who *do* have capital and income to go into hunker-mode. In hunker-mode, many investors give little regard for long-term investment opportunity, valuations or the rational deployment of capital to earn a return – instead, they see the proposition as *better to sell now and ask questions later*.

My attendance at a recent investment conference at the CFA Institute in Chicago solidified my view that it is *the highly politicized environment itself* that has created exhaustion among

professional and individual investors alike and contributed to market uncertainty and volatility. Media headlines sensationalizing the discussion with alarmist urgency also contributed to a general loss of confidence. No one feels inspired to invest based on politics. However, these environments also provide opportunities for those with long-term views. In fact, it was in an environment very similar to this in the mid 1970s that Warren Buffett established positions that worked out very well 10, 20 and 30 years later.

It's clear to me that the economy is likely in an unacknowledged stagflationary recession at present, with an extremely difficult *and very real* fiscal mess with no visionary solutions proposed by the political leadership. But amidst all the gloom, it can be difficult to see the bright spots. Here are the big ones we see:

1. The U.S. has cheap natural gas, which gives us a competitive advantage in industrial production on a global level.
2. Technology has made commerce, from procurement to distribution, exponentially more efficient, which – while causing labor force dislocations in the shorter-term – is very healthy over the longer-term. Workers will have to adapt their skill set, which will take time, perhaps even a generation, but this process will bring *pleasant* surprises and improving living standards along the way.
3. People around the world are still motivated to improve their station in life and provide a better life for their children and grandchildren.
4. The U.S. is still the foremost idea-generating, enterprising and innovative country on the planet. This is not likely to change.
5. There is an opportunity to move the political discussion in the U.S. to a more competition-related agenda, which will motivate, inspire and improve the skills of the labor force.
6. Many of the current problems are *known* and priced-in by investment markets. However, as always, there will be market volatility as we move through the adjustments and figure out the path forward.

The media punditry can be consistently relied upon to poorly frame the problem and provide irresponsible advice to its viewers by implying that everything is related to economic growth (or the lack thereof) and suggesting that the investment proposition is binary – either “risk-on” or “risk-off” positioning. This is nonsense. Instead, people are better served to turn off their televisions, to reflect unemotionally on what is happening, to read voraciously and to focus on big trends and their long-term investment implications. The short-term cannot be predicted, but an awareness and acknowledgment of the issues, solutions and their investment implications, and a renewed focus and healthier discussion in the political sphere should help bring a return of calmness and confidence to investors worldwide that will benefit us all.

Past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be suitable for an existing or prospective client's investment portfolio. Therefore, no existing or prospective client should assume that future performance of any specific investment or investment strategy (including the investments or investment strategies recommended herein) will be profitable or equal any historical performance levels. Certain portions of our newsletter may contain discussions of recommendations as of a specific prior date. Due to various factors, including changing market conditions, such discussions may no longer be reflective of current positions or recommendations. Information included herein should not be construed as the receipt of, or a substitute for, personalized individual advice. A copy of our current written disclosure statement discussing our business operations, services, and fees is available upon written request.