

January 2010: The Lost Decade of the S&P 500

Now that we have closed the ‘lost decade’ of investing with the S&P marking a negative return for the last 10 years, we can recap what transpired and explore implications for the future. In looking back and projecting what will likely turn out to be *the* big story for future historians, it appears to us that something fundamental has changed with respect to the U.S.’ place in the world.

The U.S. began the decade as the unchallenged global military hegemon and with unassailable confidence and stock market euphoria. There were two places that projected the impression of America’s business leadership: Silicon Valley, which overflowed with new ideas and new billionaires every week; and Wall Street, which began transforming itself (in the wake of the repeal of Glass-Steagall in 1999) from the basic business of corporate finance to the sexier version of investment banking. At their respective peaks, financial services comprised 22% of S&P 500 weight and technology made up 30%.

In Silicon Valley, there was a belief that the sky was *not* the limit – a belief that the NASDAQ was going to keep on going up and California would have a GDP bigger than Europe. With the big collapse of the tech mania at the beginning of the decade, the only remaining driver of wealth creation was the business of high finance.

Wall Street’s re-tooling efforts were so successful that at its pre-crash peak, 40% of S&P earnings came from the financial sector, where the historic average had been around 15%. This miraculous feat of exploding profitability came from financial engineering: the application of science and technology to the business of finance. Bankers created all kinds of new products, schemes and exotica to get away from the dull activity of taking deposits from people and relending it out to the Treasury, to corporations and to consumers. The boring business of banking simply was not able meet the salary demands of people wanting to emulate Goldman Sachs partners.



“Okay, everybody—good news, bad news. Our derivatives have gone kablooiie, but Hoffman here is the new Nobel laureate in physics.”

So the 2000s brought a situation where Silicon Valley became Death Valley, and Wall Street became Bailout Street as firms were knocked down, became wards of the state or went into extinction. The two leading sources of wealth creation and economic progress had been destroyed and the competitive position of the whole economy changed with respect to the rest of the world. To complicate matters, there aren't many areas where the U.S. *does* compete well on a global basis. This is demonstrated by yawning trade deficits, a public educational system that ranks below the global median and myriad social problems and subsidies.

China and India moved into the gap created by the collapse of America's high-flying industries, attracting liquidity to fund their explosive development. Had it not been for the emergence of China, India and the industrialization of other emerging markets around the world, America's global position may have remained relatively steady. But the rest of the world learned to re-weight their economies away from American overconsumption and to focus more internally. Yes, the dollar declined over the last decade, but it probably hasn't fallen as much as the U.S.' true competitive standing since there aren't any industries where it is clear that the U.S. is number one.

So future historians are going to say that the twin towers of the USA, both literally and figuratively, got knocked down in the first decade of the millennium and the country became vulnerable. These factors brought about political change: a move away from embracing of Reagan-style capitalism to the soaring optimism attached to greater government oversight.

Upon reflection, it makes sense that the S&P delivered below zero returns over 10 years, and our economy ended the decade with zero interest rates. The bottom line is that the dynamism of the two most robust tributes to American dominance, finance and technology, overdid their story. They got carried away with their own press clippings and hubris and there are no dominant domestic industries to take their place.

Most bull markets are led by at least one, but probably two or three sectors that are powerful globally and drive the market. The S&P doesn't have that anymore and, in our view, there is no reason to think that it will in the foreseeable future.

If you look at what *has* performed sensationally over the last decade, it has been those companies with exposure to improving competitiveness, growing economies and rising living standards abroad. These companies are energy, mineral and agricultural producers, infrastructure firms, and precious metals miners. This thesis should continue because those companies have already been through a 20-year collapse *prior to this decade* and the emerging survivors possess the best assets for the world of the future; they know how to finance themselves and to operate their businesses. When we've gone through the transformation that we're going through now, where the industries that made America dominant have passed in significance, it is difficult to make a case that an S&P 500-like portfolio should be a huge weight for global investors.

America *will* come back because it always does, but it will re-emerge into a much more competitive world. What made the pricing of American assets so strong was the perception that Americans were the best at the things that mattered most: finance and technology. These were transformative industries that built up their capital base and drove global economic activity from 1998 to 2008. It *is* true that America has lots of dynamism, talent, resources and a very bright future, but we believe that America's traditional

course has been altered. America will need to learn how to adapt to a bigger, flatter, and more tenacious world.

From an investment strategy standpoint:

- It is inevitable that interest rates will go up in the future – it’s a question of when. When thinking about this and how the investment environment will change at that point, we will find out what the real value is and where the real economic power exists because *value will stand on its own for real buyers/investors*, as opposed to where re-levered hedge funds and investment banks (that are using zero-cost funding to speculate on 1-day returns) are allocating capital.
- “Stuff” is in demand globally, and we anticipate companies that own these valuable and finite assets will increase significantly in value. One of the things about the commodity companies is that while they’re big users of capital, they are also huge generators of cash flow. As such, they’re *less* dependent on the cost of credit than they are on supply and demand and we continue to see strong demand and limited/dwindling supply.
- What has been astounding for our Investment Committee has been that given the speed and size of the 2008 crash (that was driven in large part by the crash of the shadow banking system), that the survivors would be able to dust themselves off so quickly, borrow more cheaply now than they could during the boom, and replenish their bonus pools. That the big players who blew so many billions (hundreds of billions in the case of Fannie Mae and Freddie Mac) can get all the funding they want for zero cost is nothing short of astonishing. What this demonstrates is that more punishment is needed within the system. But because the government won’t allow it within the financial sector, taxpayers will likely get punished in the form of inflation (resulting from a proliferation of paper claims issued by the U.S. government – the ultimate process of privatizing gains and socializing losses).
- Capitalism, with all of its flaws, has the underappreciated beauty of being a system designed to administer punishment for inefficiencies and excesses all on its own. With other economic systems one has to rely on governments or foreign invaders to administer the punishment, or at least re-direct it. We are not supporters of state-led interventionism to re-distribute the punishment away from where it is due, and unfortunately, the savers and risk-averse will continue to bear the cost.
- We view 2008 and 2009 as outlier years – years when the prudent application of the fundamentals of finance and investing did not show up in portfolio returns. Rather, these two years were characterized by the withdrawal of liquidity from the financial system in 2008 and its subsequent restoration in 2009. We don’t anticipate such soaring gains and gut-wrenching drops in the coming years, but they are possible.
- We submit that the 2008 liquidity crisis and the 2009’s return to quasi-normalcy were *both*, in large part, caused by government interference in financial markets. It’s difficult to forecast the intended and unintended effects of government intervention, but one thing is constant: politicians want to be re-elected and that means appealing to the greatest number of voters, whether or not policies adopted to do so are in the U.S.’ long-term best interests or not. As such, we expect more

and more liabilities to be put on future taxpayers as a way to appeal to today's voters and to alleviate current economic pressure.

The goal of investing is to keep or, hopefully, improve one's standard of living. In order to do so, investors must keep their eyes open to the world and assume some risk. As such, investing can never be a *comfortable* activity because imperfect information has to be used to make decisions about a future of an infinite number of possibilities. It's in our DNA to look at what others are doing and want to emulate what's working at the moment and to shun what is not; but this path is fraught with economic peril (although it may make investing *feel* more comfortable). The best we can do is to apply the principles of sound investing and to train ourselves to be OK with the discomfort associated with making hard investment decisions and having positions go against us, and to know that the future will not often look like what we expected.

As professional investors, we are up against a difficult backdrop set up by the successful double disgorging of Main Street by the twin pillars of excess: Silicon Valley and Wall Street. Their collapse and the government's remedy of flooding the system with liquidity (through zero-cost financing at the expense of savers), presents an opportunity for investors who understand asset quality, the principals of finance, drivers of liquidity flows, and political incentives (and who have the patience to let things unfold). While the current environment may be daunting, we believe it is a fabulous time to increase our clients' share of global wealth.

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