

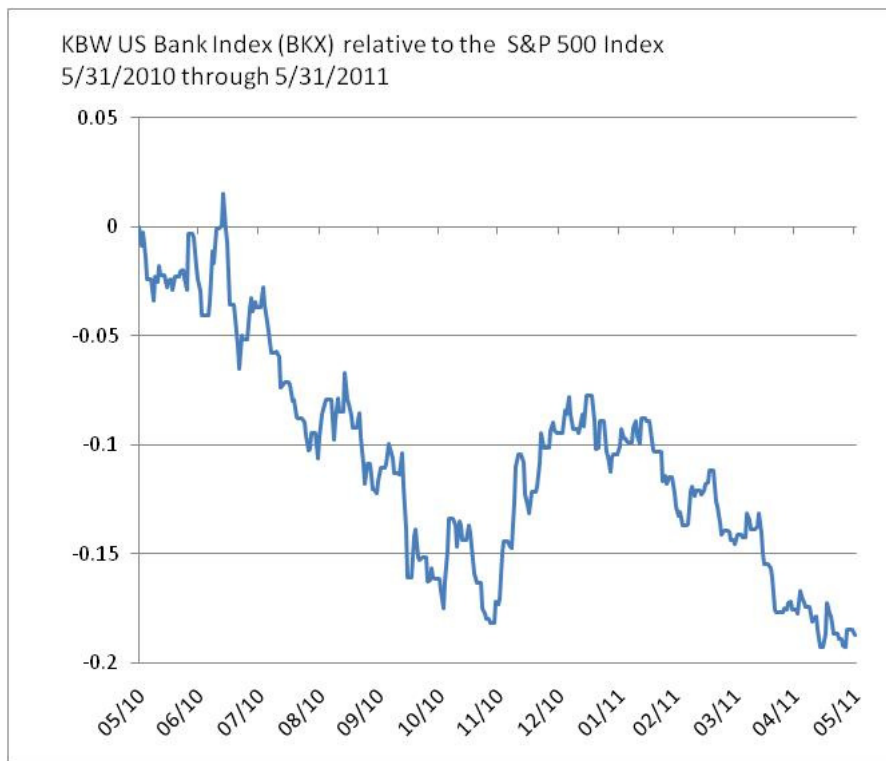
## June 2011: Banking in the Bailout Era

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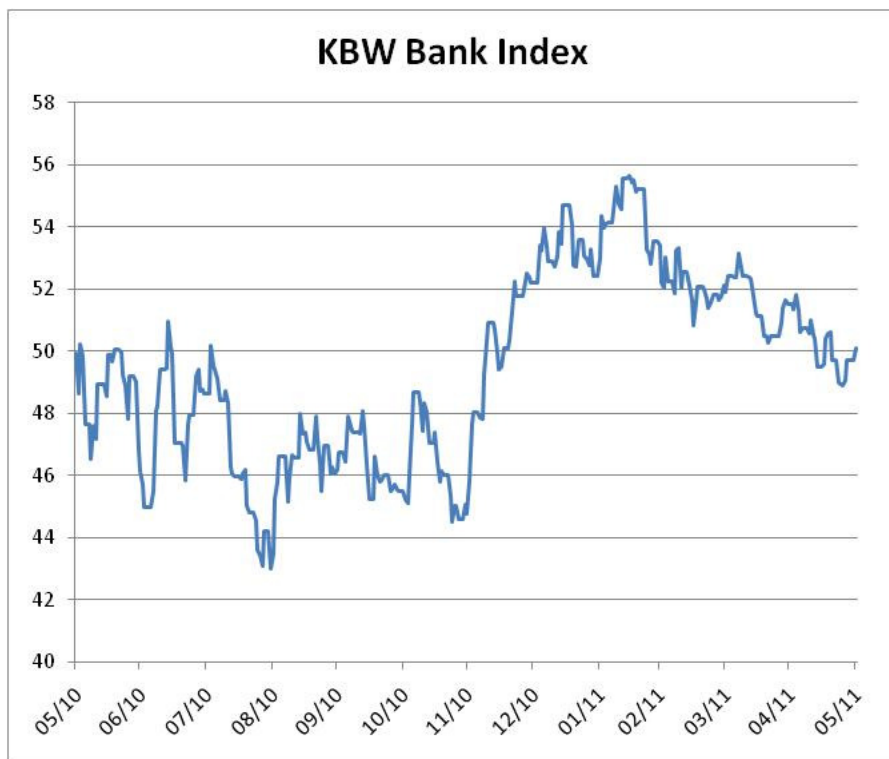
If recent market action reflects investor sentiment, the overall mood has soured. This is understandable, as some of the problems from three years ago have not gone away and market participants are beginning to re-focus on this.

After a sharp run-up in stocks and commodities since last August and as we near the end of QE2, a risk reappraisal by market participants is natural and healthy. The most recent economic statistics indicate a slowdown, and this slowdown may continue as the government weighs its short list of politically unpopular options. Fiscal stimulus is out of the question and quantitative easing is highly controversial.

To us, the current malaise can be traced back to the bad business practices of the big banks and the cost of the bailouts and other assorted government interventions. The charts below reflect the problem:<sup>1</sup>



<sup>1</sup> Source: Bloomberg



The KBW Bank Index (BKX) effectively represents the prices of big banks’ common stocks (collectively known as Wall Street) – the primary transmitters of credit into the economy. These are the institutions that have first dibs on Federal Reserve largesse and that have benefitted from nearly three years of zero interest rates. Furthermore, as bank holding companies, they also benefit from the additional subsidy of government-guaranteed deposits.<sup>2</sup> Never before has so much taxpayer money been lavished on so few for so long, but these charts indicate that banks are still generally unhealthy. We don’t expect strong stock markets or economic performance without their leadership.

Most, if not all of these banks would have vaporized long ago were it not for TARP and other taxpayer-sponsored programs. Yet many bank CEOs who cashed massive profits on stock options granted at the height of the crisis still complain about criticism leveled at them by Congress and the Obama Administration. Some major banks have even been found guilty of falsifying foreclosure documents and generally behaving badly in their zeal to make a buck. For Ben Bernanke, it must be particularly infuriating that many have used their cash flow to buy back their own declining stocks.

It’s safe to say that the banks’ behavior – both before and after the crisis – gave them their worst reputational decade in history.

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<sup>2</sup> In 2008, the last remaining investment banks (Goldman Sachs and Morgan Stanley) were converted to bank holding companies.

Ben Bernanke, Hank Paulson and Tim Geithner did more for the survival of big U.S. banks than the banks' management teams did collectively in two decades. Government sponsorship of banks helped avert multiple failures and Bernanke has continued to try to heal these institutions with incredibly easy money.

While it is unclear whether these ongoing accommodative policies provide any aggregate benefit, it *is* clear that holding rates too low punishes savers who now earn nothing on their deposits in the face of a rising cost of living. Accommodative policy also encourages people and institutions to take on leverage at a time when the system is trying to de-leverage and, as such, provides a transfer of wealth from savers to speculators. Socializing the losses born by banks is the government's chosen path.

To offset the politically unpalatable one-way largesse provided to banks and (ostensibly) to protect consumers, Congress finally got around to passing the 2319-page Dodd-Frank legislation. In doing so, it let the big banks off surprisingly easy and let the rating agencies, Freddie Mac and Fannie Mae (and their political executives, who had been paid hundreds of millions of dollars), off altogether. While the legislation didn't punish anyone, it *did* provide a second form of stimulus to the accounting, legal and lobbying industries because of its definitional vagueness and vast complexity.

A recent announcement that April housing starts were down 10% could signal that the above attempts to repair banking in order to bolster housing have not worked. The brief uptick in housing could be just that – brief. There are estimates that around half of all existing homes on the market are either foreclosures or distressed sales.<sup>3</sup> In this environment, buyers are hesitant to commit large down payments (now required for mortgage qualification) when they see foreclosures driving down values in desirable areas. Moreover, as with any other asset class that experiences 30%+ price declines, investors are loathe to participate at all.

Now that big banks and government-sponsored entities collectively own close to 1 million properties taken back in foreclosures, we wonder what it will take for the banks to admit that 1) lending and underwriting practices were reckless; 2) Ph.D-engineered derivatives packages were flawed; and 3) their ongoing refusal to write down derivatives and loans held to actual market value violates a basic principle of capitalism: full disclosure. Admitting the problem would be a good step toward healing.

While we are skeptical of the Dodd-Frank Act's effectiveness, banks *do* need to have sensible regulation imposed on them to better align their managers' reward systems with those of the shareholders. The quasi-nationalization of banking that we got in 2008 along with massive taxpayer subsidization *cannot* coexist with the private sector reward systems of yore. That obviously did not work and, in my opinion, should not be allowed if certain financial institutions are going to be deemed "too big to fail" and if their boards of directors won't do their jobs.

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<sup>3</sup> Source: Bank of Montreal

Perhaps Wall Street institutions need to be converted back into partnerships so their leaderships' personal wealth is tied to the success *or failure* of the institutions that they manage. This would instantly improve the quality of decision making at the top without a 2,300-page regulation.

As long as we're on the topic of changing laws to change behavior and outcomes, tax policy could easily be changed to curtail excessive speculation, which in large part is responsible for the excessive size of the finance and investment industry (as well as the size of its formidable lobby). This could be done by increasing the rate on short-term gains to punitive levels (say, 80% or greater), dropping long-term gain rates to zero and extending the holding period out to two years. This would force capital to be allocated in a much more efficient manner and capital would likely flow to opportunities where it is *needed* and would be invested by proven stewards.

### **Investment Strategy Implications**

As long as big banks and the Federal Reserve defer owning up to and pragmatically addressing the financial system's problems and so long as they perpetuate an environment of make-believe and denial, the "recovery" will be on shaky footing. The default government strategy will probably be to continue to debase the dollar as a way to prop up assets *in nominal terms*. This should not be difficult as the dollar lacks a universal reference asset such as gold to keep its proliferation in check.

When the dollar stops functioning as a stable unit of account, however, it can distort asset prices (a situation we alluded to in May's *Monthly Commentary*). It therefore renders price targets for anything – including stock indices – meaningless. There are lots of doomsayers out there who make dire predictions such as 400 on the S&P or 3,000 on the Dow (such predictions are omnipresent and are often made to attract media attention). But one can't forget that the S&P 500 and Dow are based on *dollar* prices of U.S. common stocks – an important point to understand. Let us explain:

People in the United States naturally measure financial outcomes in dollars because dollars are the unit of account in which their expenses and liabilities are payable. However, what does it mean that over the past 10 years, U.S. stocks' total return was +15.1% in dollar terms but was negative 78% in gold terms?<sup>4</sup> What is the proper measurement of the S&P return? Even in a non-commodity currency such as Japanese yen, over this same time period U.S. stocks were down 15% (see graph on next page) to an unhedged Japanese investor who bought the S&P (a period when Japan's economy significantly underperformed the U.S. economy). This tells us that, on a global basis, U.S. monetary policy distorts returns and is a zero-sum game *in real terms*. Nominal returns are far less important than real returns – a point the financial press ignores.

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<sup>4</sup> From Dec. 31, 2000 to Dec. 31, 2010



As foreign investors gain clarity on the intent of U.S. monetary policy, they will likely continue to be reluctant to invest in the United States without dollar hedges (selling dollars). As the dollar declines, the cost of living goes up for dollar-based citizens. In an environment of a *strengthening* dollar, one has to be careful to not read its strength as an endorsement of U.S. economic improvement, but rather as a manifestation of risk aversion because so many people borrow in dollars to invest elsewhere. If global investors *as a collective* want to reduce risk, there will be a temporary heightened demand for dollars because they need dollars to settle their dollar-denominated loans (or unwind their hedges).

In our view, further dollar debasing is likely given continued excess leverage and the political stalemate over unserviceable government debt. U.S. stock indices, therefore, are unlikely to trade dramatically lower in absolute terms. But this will not make up for the fact that the cost of living is likely to continue to rise over the longer run. Our investment strategy is to offset this effect through thoughtful security selection. While dollar debasement policy is a high long-term probability, and while this view is expressed in our investment portfolio, we expect a choppy summer while politicians and the Fed ponder an approach to the debt limit.

It's much easier to service debt by cheapening the dollar through debt monetization, such as quantitative easing (where the Federal Reserve Bank buys up Treasury bonds), but as I mentioned earlier, some investors win and some lose under such a policy. The government, however, doesn't want the political heat resulting from participants protecting themselves from

higher gas and food prices by purchasing long commodity positions. So we expect eventual quantitative easing to come with more jawboning, threats and playing with margin requirements on key commodity contracts (as we saw earlier this year).

While the government may be successful in influencing commodity prices in the short term, it will *not* be successful over the long run. A world where no one wants to have a strong currency is a world that has an inherent inflation bias. This means that overweighting commodities is a better long-term strategy than overweighting cash (but we still advise keeping enough cash for current and near-term expenses). The opportunity to buy unhedged natural reserves that are in global demand remains a solid investment concept despite recent softness in commodity prices. This will become more apparent when economic adjustments reflect renewed growth from the current slowing.

It is not part of our process to sell stocks as sentiment deteriorates. But even if it were, we're not sure at this point which is worse: bonds and cash (which we know offer large negative real returns), or good claims on good assets/businesses that have lasting value but may be marked down as risk aversion returns.

Our strategy continues to be to own good claims on real businesses that produce real things needed by real people and which are unlikely to be directly affected by the bad balance sheets of the bailed-out banks. In client portfolios, we want to emphasize businesses that have pricing power – even though stock market investors vacillate between fear of inflation and fear of deflation and mark assets accordingly.

We believe strongly that if investors are indifferent to market schizophrenia and identify compensated risks properly, their patience will be rewarded. This is especially true during a time when investor and consumer sentiment are already so dour in the first place.

As Nassim Taleb reminds us, what matters in investing is not how often you are right, but *how large the effects of your cumulative errors are*. The government will likely continue its strategy of dollar debasement to relieve the excessive systemic leverage – to ignore this could be the biggest error for many investors. While the banking industry will probably ultimately muddle through its problems with the assistance of the Fed, the recovery will come at the expense of those who have not positioned their investments properly for the effects of the solution.

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