

## November 2011: Financial Crisis Status Update

By John Goltermann, CFA CPA

To cut to the chase: we feel the end of the financial crisis is not yet in sight. However, we also feel it may not be prudent to be overly risk-averse and overweight cash and bonds at this point.

One of our primary roles as our clients' advocate is to be transparent consistently and call it like we see it. The financial crisis will likely continue because the highly politicized remedies proposed and implemented to-date are oriented toward suppressing economic pain associated with the *symptoms* of the disease, rather than remedying the disease's underlying causes.

The *symptoms* include a very weak banking system, an impaired system of credit, declining home prices, heightened unemployment, rising food and fuel prices and low levels of investor and consumer confidence. The *causes* include excessive debt, unfulfillable entitlement commitments, aging demography, poorly structured reward systems and governance lethargy in the banking sector, poor political incentives and a too-short election cycle, a culture of entitlement and speculation in the U.S. and Europe, a Federal Reserve that keeps the cost of credit systematically underpriced and a lack of transparency. A daunting set of factors to be sure.

What makes this a particularly confusing time for individuals and corporations to put long-term money to work is the unknown future direction of government policy. Congress' strategy of backstopping insolvent banks and the Federal Reserve's commitment to hold rates at zero do not address the root causes of America's problems. Instead, these actions *force taxpayers and savers to subsidize* the poor decisions, poor assumptions and poorly structured reward systems (and attendant wealth transfers) of the past, and preserve the status quo. We have ended up with a system, as Michael Lewis frames it, of "socialism for capitalists and capitalism for everyone else." By "capitalists" he means the senior executives and board members of large financial institutions and hedge funds.

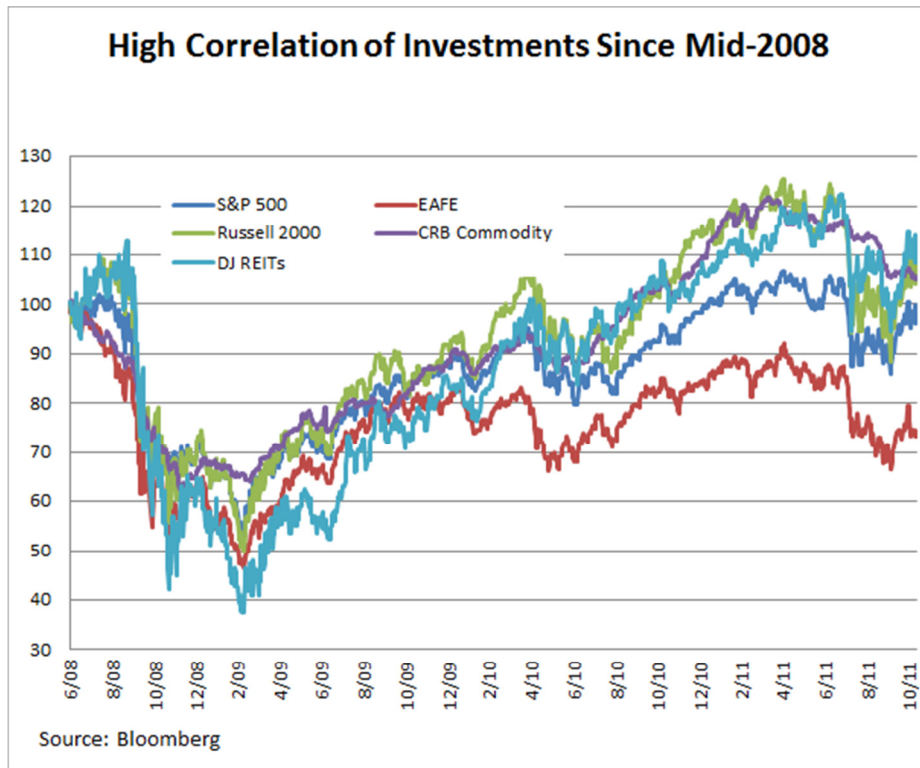
However, before you take your wealth and stuff it under your mattress, it is important to realize that the world we are in is not unique. If you examine the environment around 1974 and what a terrifying time *that* was in which to invest, it may offer some perspective and solace. At that time there was an oil embargo from Middle East suppliers, a withdrawal from Vietnam, rapidly increasing inflation, governments falling and civil unrest all around the world, extremely volatile financial markets (including a stock market down 50%), political disarray in the U.S. and a recessionary economy. Yet it proved to be one of the best times to take risk. As a rule, investors are not generally offered good opportunities when everything is fine.



One cannot know exactly how this debt crisis will unfold, nor can we predict with certainty how it will manifest itself in the prices of financial and real assets. This crisis and its evolution simply make some risks better to take than others, and they require a heightened level of awareness by those investing capital.

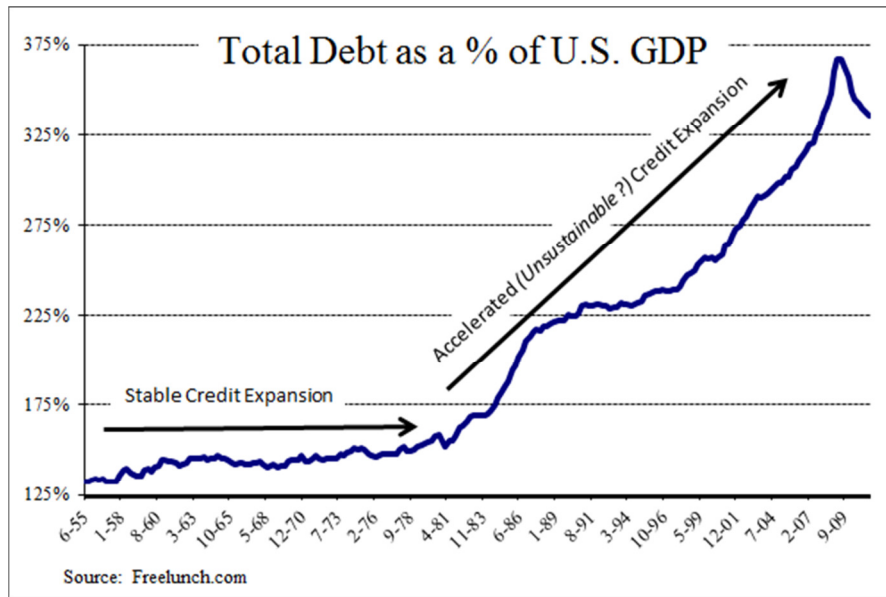
Those fleeing to cash do not escape risk in this environment. The CPI (All Items, as calculated by the Bureau of Labor Statistics, October 2011) is running at a 3.9% rate per annum, and the vast majority of savings vehicles currently pay under 1%. In our view, the annual increase in the cost of living is actually much higher, more likely to be over 7% per annum, and this *negative real rate* could easily get worse, thereby devaluing cash at an even more rapid rate.

Understandably, the alarming day-to-day headlines keep market participants on edge and stuck in a risk-on-risk-off mode — this is an environment that keeps most long-term asset prices highly correlated. The short-term orientation of market participants also contributes to this dynamic. However, we believe that this won't persist forever; as the crisis moves forward, ultimately economics will win out and those investments that are being systematically underpriced by fear and short-termism will revert to prices that better reflect their long-term value.

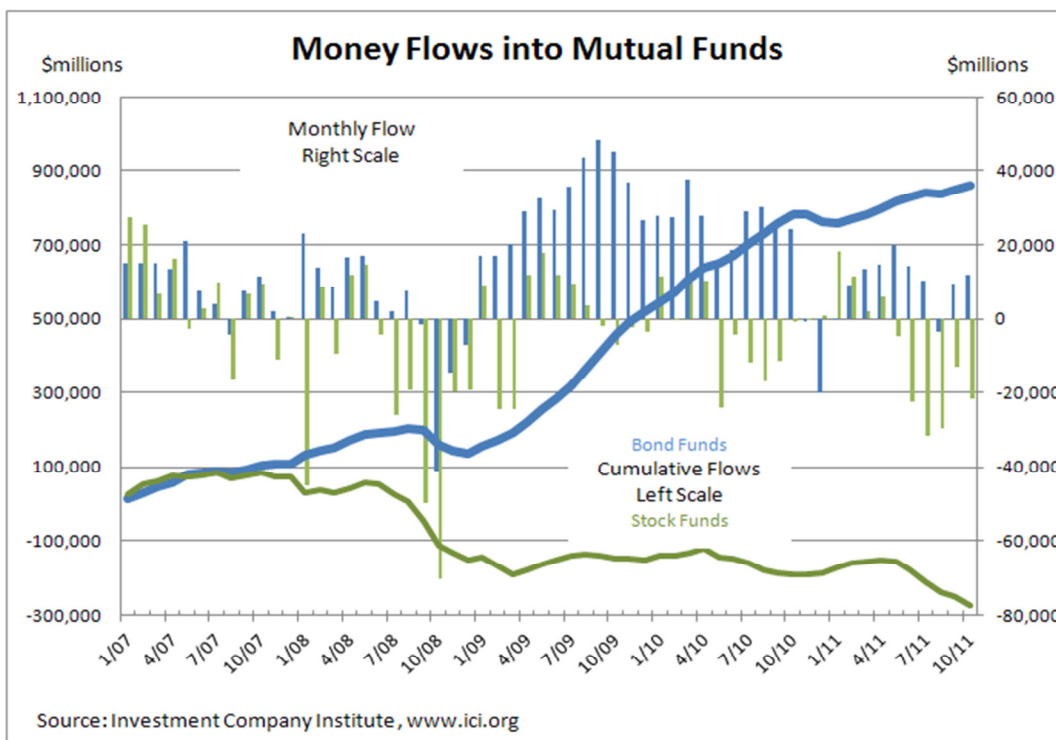


Sovereign credit risk in the U.S. and Europe, combined with the Fed flooding the banking system with new reserves, not only undermines markets' natural pricing mechanism and creates distorted incentives, but may ultimately result in inflation. The transfer of wealth from creditors to debtors is inherently inflationary. Bailouts are inherently inflationary. Debt monetization is inherently inflationary. All of this should support higher values for real assets (i.e., commodities, agriculture, real estate, etc.) over the long run. Moreover, high levels of inflation in the emerging markets could easily be exported in the prices of finished goods delivered to the United States. This would increase the squeeze on discretionary income in the “developed” markets and cause *at best* slow growth and *at worst* a nasty series of stagflationary recessions, in turn causing sustained high volatility in financial markets. But to fully understand the current issues, one must trace them back to their cultural, political and incentive-based origins (which are generally ignored by the media).

The idea that something can be had for nothing began to take hold and be validated by market-based feedback loops when the trajectory of credit expansion turned upward in the early 1980s through 2007 (see chart below). One merely had to own anything *other than cash* to accrue wealth as credit flowed freely and juiced up all sorts of asset prices and as disinflationary factors kept the cost of living, interest rates and the official inflation statistics in check (cheap labor from abroad, the peace dividend from the end of the cold war and increased productivity from technology). It was a gilded age and leverage was consistently rewarded – until it wasn't.



When the system hit its tipping point in 2007, the rebalance began with a large liquidity squeeze in mid-2008 and a dramatic sell-off in *all* asset classes. As a result *and because humans are inherently backward-looking*, investor sentiment changed from one of risk-seeking behavior to risk-avoiding behavior. Contributing to this paradigm shift was the combination of an aging U.S. demographic and the purging of the misguided belief (formed by decades of confirming evidence) that real estate was *always and every time* a solid investment. As a result, we saw massive inflows into bond funds, as depicted below.



In our view, this flow into bonds is unsustainable and will reverse course at some point as the mindset shifts once again from completely avoiding *any* volatility (note that I do not say ‘risk’ because volatility  $\neq$  risk and cash and bonds are risky) to protecting against inflation (which is already here, but not accounted for properly). The mad scramble for real assets and claims on scarce resources has yet to begin in earnest because most participants cling to traditional views of risk and overly focus on short-term *nominal* returns at the expense of considering long-term *real* returns and wealth protection.

Contributing to anxiety and risk-aversion is a lack of confidence in political solutions. With an aging demographic, skyrocketing health care inflation, high unemployment and low levels of savings, demand for government benefits has naturally increased. But the problem is that government expenditures are already well above a level that can be funded from the tax base. As a result, political discussions have become shrill, mean-spirited and unproductive because benefits are expensive, yet very few want to sacrifice or contribute to pay for them.

The high level of unemployment seen presently has been held up as a *cause* of the current economic travails. It isn’t. It is a *symptom* of a poorly structured economy and a remnant of excessive credit expansion and a culture of speculation (real estate, construction and financial services). Unemployment, while painful, is a necessary part of the realigning, re-tooling and re-balancing process. Credit expansion and speculation was fueled by the devolution of our system of finance, which is eloquently described in Mike Mayo’s recent Wall Street Journal op-ed, [“Why Wall Street Can’t Handle the Truth”](#) (click for article).

Markets are highly complex systems, much like ecosystems, and various components and drivers are interrelated in ways we cannot observe. The press recently ran a story about the birth of the 7 billionth child, reminding us that global population growth increases unabated and will continue to have long-term economic implications. Moreover, China intends to move 300 million people into cities over the next 15 years, which will also have an economic effect – but this rarely captures headlines. There are hundreds of other factors that we can’t possibly know about that will both positively and negatively impact asset prices, including cash. For this reason, it is important to have positions that serve either as beneficiaries of or hedges against future scenarios. Holding cash is a huge bet *against* higher future living costs, which in our view is a bad long-term bet.

In complex systems, such as ecosystems, unanticipated developments always occur. Certain species proliferate, food supplies run out, diseases erupt, invasions occur, species become extinct...and on and on. In our complex global financial system, politicians still believe that it can all be controlled, regulated, guided and finessed in ways that can prevent a disbursement of pain. It can’t, and it would be helpful if politicians would recognize this.

It is for this reason that in our clients’ portfolios, we prefer positions with real assets and real businesses generating real cash to back our claims. We will avoid businesses where earnings can be synthesized, conjured, harvested or otherwise manufactured. We won’t always be successful

or accurate in our analysis of the future performance of these assets simply because the future is unknowable, but we will always do our best to try to avoid a permanent loss of capital and diversify the big risks.

Integral to investing is a tolerance of market volatility (gyrating stock prices) – and an understanding that volatility is not the same as risk. Volatility matters more from a behavioral perspective than it does from an economic perspective because it tends to induce certain investors to do the wrong thing at the wrong time to their financial peril (buy aggressively in euphoric markets and sell to cash in adverse markets). Volatility itself is more related to market liquidity than it is to actual changes in the long-term nature, economic value or prospects of the underlying investments. This is extremely important to keep in mind because, going forward, tolerating *some* market volatility will likely be the price of maintaining one's standard of living.

We will also keep exposure to the global economy, through its inevitable positive and negative cycles – and through its inevitable crises. While there are no guarantees, we believe that keeping a consistent, appropriate mix of high-quality, cash-generating assets, exercising patience, monitoring developments and staying focused will provide the best course to enable our clients to preserve their wealth without undue long-term risk.

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.