

The Burden Shifts

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At some point I read an essay titled “The Loser’s Game” written by well-respected investment adviser Charles D. Ellis, probably in 1985, 1986 or 1987 when studying for the three CFA examinations.

At that time there were not that many of us, the exam was given just once a year, and we aspiring candidates spent most of a year reading through a pile of books and journals in preparation for hours of examination on the first weekend in June. I recall the room on the campus of Southern Methodist University being full of bright young professionals with MBA degrees of recent vintage and a polished manner. Looking at this handsome group of candidates during the final third exam in 1987, this essay – written by a man with years of experience, degrees from both Yale and Harvard, professor, practitioner, author, on and on – came to mind.

Dr. Ellis submitted a compelling argument that the entire investment management business was a Loser’s Game. (I did consider that he wrote the article in 1975 following one of the worst bear markets in history and that, frankly, perhaps he was still just in a bad mood.) I smiled in wondering about the future prospects of the people assembled in that large lecture room.

The essay’s conclusion was that investors will not perform as well as the market over the long term. Yes, much has changed in the investment industry in the three dozen years since its writing. Many of the parameters on trading costs and other assumptions would now need to be adjusted and updated, but in some ways the game is even more difficult today than it was then. Yet human nature has not changed, and this essay has remained so important to me, that it was the first article I posted on the firm’s website library. It remains there and I encourage you to read it, with some acknowledgement of the risk that you may fire us and never talk to another investment manager again.

I believe you will enjoy his comparison of professional vs amateur tennis, politics, card games, military strategy, and the importance of avoiding mistakes. Great paintings, movies, poems, and I suppose essays contain subtleties that become more deeply appreciated with time and further reflection. Wouldn’t it be odd if an essay on the futility of investment management actually contained certain ingredients critical to the foundations of successful investment management?

I mention this for two reasons; first, because in recent months we’ve clearly made some mistakes in terms of short-term tactic, as is often the case. We wrote in August that the choppy sideways equity market of 2010 was *“ready to break out... one hopes that it will be to the upside though this would*

appear to require policy decisions that seem unlikely at this point.” You know that our mental bias was for US equities to break to the downside and that bias could not have been more wrong.

Despite this, somehow our aggregate equity performance results ended up exceeding the S&P 500 return again in 2010. Some say we've been winning the Loser's Game. As a number of client portfolios did not beat the index last year, be assured that such aggregate outperformance was undeserved in my own mind. So much so that I find myself leery of dark clouds for fear of lightning, or perhaps a grueling IRS audit or some other imagined occurrence, as if to “even things out.”

I mention the essay for a second reason, and you'll actually have to read Dr. Ellis' essay online to fully appreciate our comments here. During the course of a market cycle, investor behavior rotates between an enthusiasm to play a Winner's Game and a resignation to acknowledge a Loser's Game. If reversing such normal human nature could place you in the minority of successful participants in the game, is February 2011 a time to be careful to avoid mistakes or a time to “go for it”? No one can predict the future, but the reality of money management is to be assured of soon facing a need to avoid mistakes while appearing to make brilliant winning decisions.

Equity Values and the Economy

I don't want to quickly gloss over the unexpected strength in US stocks beginning late last summer. We track many indicators and datasets, both fundamental/economic and technical/behavioral statistics. One important mathematical indicator we monitor, often correlated with past inflection points, suggested in August that the market was about to break out of its sloppy 2010 trading range. It was going to break one way or the other.

Short Cycles

Indeed it did, and within weeks it was resolved that it would be new highs for the year rather than new lows. The surge beginning in the latter months of 2010 partly developed from the power of confidence in a grass-roots driven election, and presumed policy shifts suggesting federal economic initiatives might transition towards the middle grounds similar to the supposed changes from President Clinton in 1994-95.

The extension of the Bush tax policies may well have factored into this rally. The surge would also appear to have been partly fueled by a flood of money per a second round of quantitative credit easing from the Federal Reserve. Now, we've asked before, can a debt problem be solved with more debt? That is a tough path to follow. A favorite report, written in January of 2009, compared such actions with Ponzi schemes and is now probably appropriate to read again two years later for several reasons.

These unprecedented government actions are said to have been necessary to create some semblance of an economic recovery, juicing the stock market in an effort to create some positive buzz and “wealth effect” on the economy as well. The degree of daily volume devoted to short-term trading in the US stock market is quite incredible and Wall Street can be relied upon to respond very nicely to any perceived short-term buzz. If this were a tennis match, Bernanke is firing away with attempts to serve up aces.

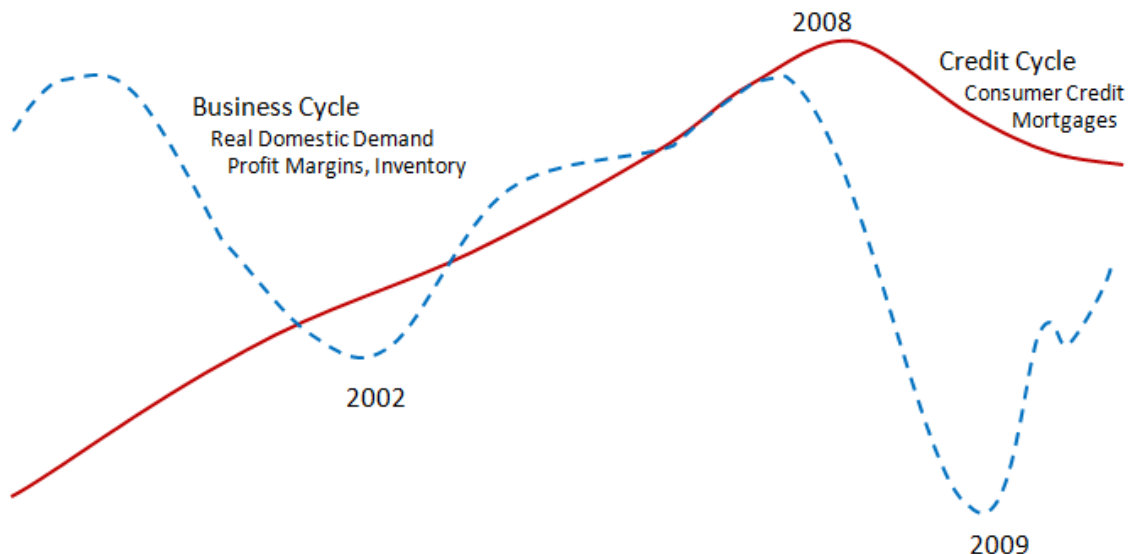
These influences do also impact marginal economic activity. However, it's not clear that low interest rates and incredible sums of QE credit easing will stimulate capital investment and borrowing during a deleveraging cycle. It is what some observers refer to as a “liquidity trap,” as so much of this Happy Money has found a home in the capital markets rather than in capital equipment.

Such liquidity impacts the markets as we've seen, but the core problem in the economy is not a cash management or liquidity problem. Policy decisions have been largely focused on such short-cycle factors...influencing the types of decisions that Wall Street now makes instead of Main Street.

Long Cycles

In September of 2008 we wrote that the final stages of the deleveraging process of this credit cycle would occupy a prolonged period of time. We called it “Phase Three,” partly because we lack imagination, but also because after the preceding “Strike One” and “Strike Two” discussions, the term “Strike Three” did not seem appropriate for what was likely to be a longer drawn-out process of deleveraging, reducing one’s debt voluntarily or involuntarily. It turns out that, when looking only at the stock market, Strike Three would have been a proper term because the collapse was very sharp indeed; but a superior description of the concept in terms of the economy was PIMCO’s Mohamed El-Erian’s phrase “The New Normal”... a prolonged phase of below-average economic experience from efforts to deal with high levels of debt, increased regulation, and unemployment. That outlook was described in his May 2009 writing still available on their website. These are long-cycle themes, multi-year influences...the types of decisions that Main Street is now making instead of Wall Street.

As such, it can be useful to separate the short-cycle influences from the long-cycle in interpreting daily economic news – or perhaps to combine them. Over the past year I’ve attempted to sketch this drawing in several client meetings, with sometimes humorous artistic results. The idea was to combine the short-cycle and long-cycle influences to help understand the daily media reports.



Deleveraging affects consumer demand, capital investment, consumer credit, construction spending, so many things; and in the face of sluggish demand, good corporate managers cut costs, layoff employees, postpone hiring and wage increases, combine operations, and so on. The short-term result can be strong earnings on sluggish sales with increased productivity, which sounds like 2010.

The policy game has been to replace the negative impact of consumer and corporate deleveraging with increased federal debt loads. The debt burden has shifted, we all know this. Since the deleveraging of an unwinding credit cycle is deflationary (and there is excess capacity in so many parts of the economy including labor), the government has been in a position to flood the economy with incredible levels of liquidity while smiling at the loud fears of inflation for over two years. The game is to use short-cycle strategies to juice confidence back to equilibrium levels of economic activity and hope economic growth can minimize the longer term issues.

If successful, and the long-term credit cycle in the private sector returns back to an equilibrium before being trumped by credit excesses in the public sector, then secular increases in inflation could become problematic (much more so than these cyclical commodity price moves we’ve seen). If the inflation is not excessive, it could be a reasonable price to pay for the profits from now highly efficient corporations enjoying, hopefully, truly strong future rebounds in demand.

We have reached a point now however, that a New Normal type of economy is no longer enough. We need to see historically strong economic growth, meaningful improvements in employment.

One could say the burden is now shifting from Wall Street to Main Street. Wall Street has played the game, the capital markets have now done their part, you're over 12,000 on the DJIA and real interest rates remain rather low. Players are taking those risks. These short-term-oriented capital markets are playing their Winner's Game eager to serve up aces like a professional tennis player.

Main Street businesses and consumers have for the most part been playing the way a smart player would in a Loser's Game, trying to avoid mistakes, thinking long-term before making big decisions about employees and business investment and buying a house.

It's time to see it, the burden has shifted.
Main Street, it's your serve.

Municipals and Interest Rates

The particular niche of the municipal bond market that we have been focused on seems to have held up well in the volatility of recent months. The cost burdens of many programs are increasingly being shifted from Federal and State levels to County and Municipal governments. We continue to think this may result in some interesting combinations of entities as local governments struggle with budgets. The strongest of credit qualities, and avoiding long bonds, has been a key to maintaining value lately.

This strategy remains important for tax-exempt investments. If the economy were to roll over, interest rates might well decline again and certain income investments would perform well, but the strains on municipal credit quality would very much increase. On the other hand, if inflation were to increase beyond the current supply/demand imbalances in some commodity markets, being locked into long-term bond investments could become pretty uncomfortable. As you know, our approach to the fixed income investments has been focused on a particular strategy that balances these risks and returns.

As this is written, I feel I need to shift some focus towards the anti-government protests in Cairo Egypt. This is increasingly dominating the news today, and the stock market is selling off as we approach the close of trading. It seems logical that social unrest could stem from inflation in food and necessities, from a young adult male population unable to find employment, from wider income gaps between rich and poor, and so on. It is rising in many countries of the world, even the US to some extent. The events in Tunisia and Egypt must be causing a stir in Iran, both as an opportunity for Iran and as a warning.

Egypt is the most significant ally the U.S. has in the Arab world. If a change occurs, and the U.S. loses such a strategic ally, that could be a very negative security situation. Oil prices would rise in the very near-term on fear. To the extent that oil prices continue to trend higher from here however, this becomes yet another burden for the economy to overcome... and the basic theme for this commentary today is that the burden has shifted to Main Street. It's time to deliver something more than just "a new normal" experience. If today is an indication that volatility is about to increase, it will become more important to avoid mistakes than serving aces.

-Brian

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