October 1, 2009

2009 Third Quarter Review

It was just a little over a year ago that Lehman Brothers failed and triggered the unraveling of the global financial markets. In the past year we have seen a historic crash and a historic rebound in those markets. The third quarter continued the rebound from the lows of early March, when panic reigned and depression loomed before us as a real possibility. With the help of unprecedented intervention by the U.S. government, the Dow Jones Index has rebounded to a positive 10.66% for the year, after having being down as much as 25% in early March (on top of a 34% decline in 2008). U.S. government bonds were not a good place to be as the long term maturities index fell over 10%. Corporate bond indexes, however, rallied 15% as the world looked like it may not come to an end and bond holders might get paid their coupons. In a strategy to repair the banking system at the expense of the savers of the world, the Federal Reserve has reduced short term rates to record low levels, with 3 month Treasury Bills now yielding 0.09%.

I am often reminded lately that the goal of the long term investor is survival. Surviving this year has not been easy, and we have benefited from our caution as the markets crashed, and then been held back by it as markets rebounded. That caution has reduced volatility for us. The true test is the long term compounding rate of the value of accounts, the most important aspect of which is the avoidance of debilitating loss. As we pick and choose our investments, we are rebuilding portfolio holdings for the "new normal" that is now unfolding. Because of the rare, if not unprecedented, nature of the events of the past year, the range of possible outcomes is wider than usual.

The government's response to the financial crisis can be compared to releasing a tidal wave of cash. That tidal wave has lifted a lot of boats. The recent rally in the stock market was initially regarded as a "snap-back" rally to less-panicked levels of value. However, as the rise in prices continued it became clear that the liquidity provided by the government funds was sloshing around and inflating the value of financial assets instead of being put directly to use in the economy. As the programs proliferated from housing credits to cash for clunkers, some analysts have begun to call it the "infinite intervention," with the resulting rise in stocks being called a "liquidity rally." They think that the rise in stock prices is based less upon improving economics than on an excess of cheap money being made available by the Fed. The problem, they say, is that all these programs are meant to be temporary. More recently, investors have started focusing on the problems that may appear when the "infinite interventions" wind down and the cash stops flowing. The most important question will be, "Is the recovery sustainable without the interventions?"

The stock market rally from March lows has recently been referred to as the "most hated rally in history" since most investors, individual and professional, have been unwilling to wade very far back into the waters that so nearly drowned them so recently. The pain of any given loss is greater than the satisfaction of the same magnitude of gain. The lingering trauma of the crash has left a psychological scar on investors that will persist until markets go up and stay up for a while. At that point, the average investor will be more comfortable buying stocks. Of course, that will likely be a better time to be a seller than a buyer.

In a case of almost perfect symmetry, I received several calls with instructions to sell the rest of our stocks and get out of market in March and subsequent calls giving permission to begin to increase percentages of stock in September. Since March may prove to be a "generational low" for stocks, and September saw substantially higher prices, a stock chart would show how ill-timed that move would have been. This normal and understandable emotional reaction to market swings is a good example of the counter-intuitive nature of successful investing at those extremes.

The bull (up) and the bear (down) cases for the stock market are roughly as follows:

The bulls believe the cost cutting and inventory reduction has made corporate America lean and mean again, and that any pick-up in revenues will result in robust profitability, which will increase employment, which will increase revenue, which will increase profits. Then we are off to the races again with a self-sustaining recovery.

The bears believe that the markets have already “priced in” a reasonable amount of the economic recovery and that non-traditional headwinds will create disappointment in the quarters to come. The consumer will move from “aspirational spending” to a post-Depression type maintenance of the status quo. Savings rates will increase, further depressing consumer spending. Employment will therefore remain weak. Even states and municipalities, that traditionally offer stability in slack economic times, will be cutting back. Commercial real estate will be the next economic shoe to drop. “Cash for clunkers” and other incentives just succeeded in moving demand forward and will result in greater slumps when ended. Finally, the “infinite intervention” will be withdrawn and the tide will go out, leaving a lot of bathers suddenly naked and much less than attractive.

In poker terms, the Treasury and Fed have gone "all in." Economic medicine that was previously meted out by the cupful (pumping dollars into the economy) has recently been dispensed by the barrel. These once-unthinkable dosages will almost certainly bring on unwelcome aftereffects. Their precise nature is anyone's guess, though one likely consequence is an onslaught of inflation.
-- Charles Munger, Berkshire Hathaway

Inflationists and deflationists are at odds as well. John Paulson, the wildly successful hedge fund manager, has made a big bet on gold as a hedge against the return of inflation. Bill Gross, the extremely successful fund manager at Pimco, has made a large bet on *deflation* by buying a huge amount of long-term U.S. government bonds (which will get killed if inflation and interest rates rise.) Energy bulls point to tension with Iran as a positive for energy shares; while oil and gas supplies have increased to historically high levels, giving the bears reason to expect lower prices.

When working on an economic forecast, two equations can take into account exactly the same variables and, by weighting them differently, arrive at extremely diverse outcomes. Is the positive factor twice or half as strong as a negative factor? Which variables will have the overriding influence? Even if we knew all the variables, no one could be certain which of these scenarios will occur. However, history shows that rallies of the magnitude we’ve seen off the March lows have never held without a subsequent pull back. That is to say that markets haven’t gone up in a straight line this far for much longer than this.

If anyone doesn’t believe that markets can get ahead of reality, consider this: China’s stock market has already retraced 20% from its recent highs. Japan’s Nikkei Index dropped below 10,000 again just last night. Almost 20 years ago it was almost 40,000.

Several times during my Wall Street career I have seen markets where “cash is trash.” Short term rates are low and stocks are rising, leaving anyone with cash reserves wondering why they don’t just go “all in.” Usually, it only becomes apparent why they shouldn’t just after they have. At the extreme, this "chasing performance" can cause a "melt-up" when the last of the resisters finally succumbs and buys into the rally. There is the potential for that scenario taking place in this fourth quarter as short term rates are low and stocks have rallied. "Melt-ups" can also be "blow-off tops" when a rising market "goes parabolic" in a panic of buying (see the first quarter of 2000, the end of the "tech bubble"). They are the inverse of the panic selling we saw in March, and they almost always end badly. We intend to avoid that chase if it does develop

Our strategy has been to sidestep the crash as much as possible, then begin rebuilding our portfolios with the investments we'd like to own for the next several years. We continue to move incrementally. These new investments would include stocks in recession resistant companies with potential growth and good dividends, inflation hedges, "too cheap not to own" (deep value) special situations, income producing investments, energy companies, and, in order to be prepared, a few levered to a rebounding economy. Warren Buffet is fond of quoting Ben Graham's saying, "In the short run, the market is a voting machine, but in the long run it is a weighing machine." We will continue to try to demand a little more heft to our investments in order to get the extra value and added safety that it might provide.

Enclosed you will find your third quarter reports and statements. I always welcome your calls if you'd like to discuss your investments. I hope that the next 12 months are less "eventful" than the last 12 have been, and more prosperous as well.

Sincerely,

Claude Carmichael CFA