the advisor

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The End of Days

"If Treasuries outperform stocks, then capitalism is dead."

Donald Coxe

Is capitalism dead?

As of the date of writing, the return on the S&P500 for the past 10 years is negative. Those holding the S&P index over the last ten years have made nothing! According to Ibbotson Associates, long Treasury bonds have outperformed the S&P500 on a total return basis over five, ten and 25-year periods, "and by substantial amounts."[1]

A principal cause of the current financial crisis was the mandate by the US Congress in 1993 for the Federal National Mortgage Association (Fannie Mae) to vastly increase its support of low-income housing. This mandate required a lowering of lending standards that set the stage for a mortgage crisis of record proportions.

The problem was aggravated by obscure, highly leveraged credit derivatives and structured products based on unsound mortgages that were not well understood by the parties that used them. The

Four Bad Bear Markets

Dow in 1929-1932; S&P 500 in 1973-74, 2000-02, 2007-09

dshort.com
4/2/2009

Crash of 1929
Current Bear
1973 Oil Crisis
Tech Crash
-47.9%
-48.2%
-49.1%
-56.8%
-89.2%

Dow Crash of 1929: 9/3/1929 - 7/8/1932 (34.2 months)
1973 Oil Crisis: 1/11/1973 - 10/3/1974 (20.7 months)
Tech Crash: 3/24/2000 - 10/9/2002 (30.5 months)
Current Bear: 10/9/2007 - ? (17.8 months so far)

Currently -46.7% Up 23.3% from low

<--- Months --->

supply of these speculative vehicles frequently exceeded the total amount of underlying debt by more than 1000%.

These derivatives caused an information crisis in which parties refused to enter into transactions with each other whenever doing so involved counter-party risk because no one knew who held bad paper. So what we have is really not so much a liquidity crisis as an information crisis. This has evolved into a crisis of confidence. Attacks on capitalism, which could threaten the survival of free markets, have been the result.

Are the attacks on capitalism misplaced? Simply put, capitalism is the freedom of the individual to deploy their assets as they see fit – to buy and to sell goods and services at prices that both parties to the transaction believe represents reasonable value. Is there a better system of economic freedom?[2]

The global financial crisis does not mean that capitalism is dead or is a bad thing. A decline in markets does not mean that markets have failed. On the contrary, it shows that *markets are working*. It shows that risk does, after all, have a downside from time to time. One may wish to change one's risk tolerance, but condemning and over-regulating markets makes no sense.

The freedom to make contracts in the property, stock and credit markets has produced highly negative results for so many people that society seems to want its future exposure reduced.

The fact that prices fall is not the fault of free markets; it is the fault of the individual for buying assets in ignorance of his risk tolerance and of the subsequently discovered fact that he overpaid for them. When the individual hurts more than he can bear, the sensible approach is not to over-regulate the market (economic freedom) but, rather, to protect himself against downside exposure. One direct way is to allocate his assets more conservatively and thereby reduce the range of downside outcomes. A refinement of this is for the individual to buy securities at reasonable prices. In other words, value investing.

Empirical studies demonstrate that, over the long term (defined as 30 years or more), value investing tends to outperform other investment styles. The trouble is that value stocks, along with growth stocks, also tend to perform poorly during a bear market. Tantalising opportunities to buy seemingly enduring franchises for prices well below their peaks become painful lessons in risk management and diversification. Low prices don't necessarily mean good investments.

The financial payoff, or much of it, comes on the rebound. A study by Al Frank Funds shows that, following years with more than 30 percent drops on the S&P500, large value stocks return 117% over the subsequent three years on average versus 29% for growth stocks.[3]

The return potential is mouth-watering. At the bottom of the 1974 bear market, Warren Buffett quipped he felt "like an oversexed guy in a whorehouse." The lows of 1974 presented opportunities with many companies selling below their liquidation value. There may be greater value on offer now than has been seen in a generation but there is also greater uncertainty. Nevertheless, trying to pick a bottom is counter-productive. Missing the current opportunity will be a mistake, even if this turns out to be a false bottom.

The market does not turn when it sees a light at the end of the tunnel. It turns when all looks black, but just a shade less black than the day before.

According to market historian and investment strategist, Barton Biggs, "Equity markets are wise. The investor crowd has great intuitive wisdom. Stock markets, in their long run judgements, are the perfect, dispassionate, separately but directionally motivated crowd. . . . History usually doesn't evolve in a slow and orderly way; often it leaps forward in disorderly, chaotic jumps. . . . Equities are the place to be in the long run because of their proven and virtually unique ability to increase the purchasing power of capital."[4]

As long as humans dream of financial independence then free markets will survive.

Long live capitalism.

Sources:

1. Basic Points, Donald Coxe, Mar. 2009
2. 'The Second Moment', Don Ezra, Financial Analysts Journal, Feb. 2009
3. Financial Times, Spencer Jakab, 14 Mar. 2009
4. Wealth, War and Wisdom, Barton Biggs, Published by John Wiley & Sons, 2008
5. Chart: Four Bad Bear Markets, dshort.com, Apr. 2009

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