Capital Drain

Rick's investment opinion newsletter March/April 2005 v.1 no.4

Hi Readers,

I'm still casting about for a new name for the newsletter, something a little less flippant without becoming truly boring. I'm eager to hear any ideas that pop into your heads.

OK, let's go. In my opinion:

Executive Summary:

Behavioral Finance tip: Financial insights from cable TV? You'd be far better off watching the History Channel than CNBC.

The Dollar: Do you recall who it was who finally broke the inflation of the 70s? No, not Greenspan, before him: Paul Volker. He was tough & disciplined and put economics before politics.
What does he say about the dollar now? "An Economy on Thin Ice."

Macroeconomics: Since last month the news for the economy has steadily worsened; there is, in fact, no good news except that nothing really awful has happened yet. Stocks would be doing well to break even for the year. Sell some winners that seem to be waffling now; definitely clean out the closet of losers.

As before, I think everyone is best off with a broad diversification that includes at least 3/4 overseas assets, reflecting the distribution of world economic activity.
These are not the best of times, so investors need to be in the best of securities: stick to value, to safety, to short maturities (for debt), and call me if you're concerned about anything you're holding.

Above all, avoid the investments that are at all-time extreme valuations: junk bonds, developing-country bonds, and headline-grabbing stocks such as Google or Taser.

The Details:

"My concern is with the future since I plan to spend the rest of my life there"
- Charles F. Kettering

"Predicting the future is a tricky business. Just explaining the past is difficult enough."
- Prof. Robert A. Collins

Sheesh, why does Rick keep ranting about **the dollar**?

Because the current currency imbalance is like a massive snowfield poised above an idyllic Alpine town. One of these days someone will sneeze or slam a door, and the whole mountainside will come roaring down. If you listen carefully, you can hear the stresses in the snowpack groaning.

As of last Sunday, you no longer have to take my word for it. Paul Volker, previous Chairman of the Federal Reserve, put in his two cents: "An Economy on Thin Ice." Volker was an Undersecretary of the Treasury under Nixon, and was appointed to the Fed by President Carter. He had the guts to stand up to Washington's expediency-before-economics politics. Volker saw that the only way to end the inflation of the 1970s was to raise interest rates a lot, even though that would cause a deep, politically dangerous recession (which temporarily caused my first job offer after college to be withdrawn!). Today he is showing that age hasn't dulled his spirit; his straight talk about the folly of excess indulgence and debt (personal and governmental) isn't apocalyptic, but it is sensible, firm, and calls for action.

You can also read a nice piece by Morgan Stanley's Chief Economist Stephen Roach, in which he amplifies on Volker's comments.

In a nutshell: an historically extremely unusual situation is putting a lot of pressure on the dollar to depreciate, although this is most often described now as pressure for China and Japan to let their currencies appreciate.

If you're holding dollar-denominated assets when the dollar drops 30% relative to the world's currencies, you lose 30% of your spending power for anything except pure domestic goods. You can still buy eggs or apples, but sneakers and DVD players and oil will suddenly, magically, cost 30% more.

The way to guard against this is to have some relatively large portion of your investments in overseas assets. You can still find the same types of assets you like: value stocks or government bonds or whatEVerr. But if the dollar falls x%, the money that's parked overseas will be able to come home appreciated by that same x%.

So, as I said last time:

1) I expect that the dollar will continue sliding sooner rather than later. Maybe not, but that's my expectation.

2) Even if it doesn't go down, it sure as heck won't go up. Thus, investments diversified overseas have negligible downside currency risk, have as good a chance to perform well as dollar investments, and have the advantage of being the right place to be standing if the dollar dam breaks.

If you're still curious, you can read more about the dollar's precarious position in my previous letter.

That was a long riff on the dollar, so I'll be merciful and give you just a short one on **Macroeconomics**. Stock prices try to predict future corporate profits, but the predictions tend to come from projecting current conditions into the future! The problem is that when things look rosy, people start to project that they'll always be rosy. Thus, stock prices get bid up to unsustainable levels, "priced for perfection." When the economy gets less rosy, then the stock prices look too high.

This cycle particularly matters right now. From lows in 2001, corporate profits have been rising for four years. In fact, even the profit margins have been rising, i.e., the profit as a percentage of overall sales. That's typical of the recovery from a recession.

The next typical step of the recovery is that profit growth slows dramatically. It's still a growing economy, not the start of a recession. The companies mostly still make profits, but smaller and smaller ones. The rosy projections of ever-increasing profits, however, suddenly hit the reality of flat and variable performance. Earnings disappointments lead to lowered expectations and lower stock prices.

That's likely to be our story for this year and perhaps another few. The best years of this recovery are probably behind us.

Stock prices can, of course, do anything. They're notoriously volatile and unpredictable (and frustrating!) in the very short run. In any longer run, however, they do adjust to profit levels. That means we're probably coming into a period when stocks will do less well.

In particular, growth stocks, whose prices are bid up by expectations of ever-compounding growth, are likely to do least well. By contrast, value stocks, whose prices reflect proven and steady earning capacity, are likely to do better.

This would be a good time to be sure that the portion of your portfolio which is in US stocks should be in relatively reliable value (low P/E, perhaps dividend-paying) stocks. Many no-load mutual funds provide an easy way to get a well-diversified selection of value stocks.

BeFi

Behavioral Finance in a nutshell is: to err is human, including humans who make investments.

One suite of errors that people not just make, but are systematically prone to, centers around our attention span. We tend to give the most weight to experiences which are most recent, a habit called the Availability bias.

So imagine: if you were exposed to an investment news source that overwhelmingly featured good investment news, rosy projections, and recent success stories, might you not come to think that the investing environment is good and getting better? I think so.

CNBC is such a rosy news source. Why should I accuse them of bias? Because their ratings (and thus their ad revenue) clearly, historically, go up when market sentiment is up, and down in bear markets. They have every incentive to try to tell the cheeriest, most encouraging version of financial events that they can within sometimes loose limits of honesty.

They don't have to lie to be misleading; they only have to be good entertainers and emphasize the positive. Perhaps without even meaning to, they act as cheerleaders for the market, raising estimates after every up day and calling bottoms after every drop.

I don't mean to pick on the NBC organization alone. All the cable-TV financial news suffers the same problem. CNBC is just the surviving king of the hill after others such as CNNfn have shut down.

If you want good investment news, I recommend that you go for less quantity and more quality. My favorite is the weekly magazine (they call themselves a newspaper) The Economist. It also has the virtues of being literate, thoughtful, and covering world news extremely well.

If you must watch cable TV, you'd probably get just as much investment benefit from watching the History Channel. Maybe more. Instead of being inundated with ephemeral trivia, some of the history shows might help with insights about the longer-term and larger ebb and flow of economies and markets.

It’s time to wrap it and ship it.

If you have any questions, please please write or phone. If you want to read more, I’ve got a web site with old editions of this letter and some links to other sites.

Please feel free to forward this to any friends or associates who may be interested.

Again, for those of you getting this sample gratis, I charge $120/year for this newsletter. If you're not sure you like it, you could subscribe for 3 months for $40. Your checks, mailed to the address below, are always welcome and will be appreciated.

Take care,

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"Our doubts are traitors,
And make us lose the good that we oft might win,
By fearing to attempt."
--W. Shakespeare

A collection of fine industrial Boilerplate, but true:

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