Rohr Report

The Fiddler's Notion℠

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Un-Learning

Investors

Ms. Gloria Steinem famously once said, "The first problem for all of us, men and women, is not to learn, but to unlearn." While she was obviously referring to gender relationships and awareness, that is a very good precept for investors who wish to pursue enlightened self-interest in their portfolio management to remember.

Too much of what passes for qualified financial and investment advice is not much more than a lot of folks who rely consistently on the inexorable upward trend of equities. And some of what the public hears is indeed useful for long periods of time.

However, every couple of generations or so 'buy-and-hold' meets up with some form of the *Super-Cycle Correction*℠, and is almost derailed. Considering investments as long-term "trade" positions seems too complex and nerve-racking and too speculative for the general public. And the lack of interest in efforts to understand cycles and trends is aided and abetted by the legions of brokers and advisers who for the most part want to get paid for being smarter than the client.

That said, the current situation is just the sort of traumatic education by icy blast that it takes to have the general investing public question what it is they have paid for in either brokerage commissions or annual wealth management fees. The issue is not whether they need to make an avocation out of market analysis. It is more so a matter of the minimal amount of education necessary to understand two simple facts of investment life.

The first of these is how to understand the basics of market trends and cycles. While that may sound daunting to most novices, there are some straight forward techniques by which anyone who wants to invest the minimal amount of time can become aware of broad strokes market tendencies.

The second investment fact of life that all successful traders or portfolio managers appreciate from very early in their career is the concept of asset allocation. That does not just mean among subsets of one asset class such as equities. It also has much to do with how one spreads their investments between different asset classes.

There has been much made in recent years of the degree to which people living longer means folks should be happy to ride out the cycle with a buy-and-hold equities strategy. Which is exactly why there is so much pain-and-suffering at present among so many investors who were led to believe it is a never ending cycle of serial new highs.

It seems that what the investing public needs to "un-learn" is the idea that buy-and-hold always works out in the long run. It is the received wisdom from the brokerage and wealth management industries that "if you have not sold, you have not really taken a loss." We suspect that brokers or wealth management advisors who attempt to comfort clients in the current environment with that sort of standard folderol is likely in for a very interesting conversation.

"Eternal vigilance is the price of liberty" is a quote that is often misattributed to Thomas Jefferson when the actual source was a man who was not even born until Jefferson was quite old. That was Wendell Phillips (1811-1884), an exceptional American orator and agitator, advocate and lawyer, writer and debater. The nature of that statement should be no surprise from someone who was also a highly active abolitionist in the years leading up to the American Civil War.

What we do know Jefferson did indeed say was, "I have no fear that the result of our experiment will be that men may be trusted to govern themselves without a master." While that may be an extremely enlightened view of how people should structure their affairs among themselves, it seems that a certain Mr. Greenspan has had to recently allow that greater direction from above is necessary to restrain the worst instincts of some of the Masters of the Universe in the financial services industry.

The combined lesson there for enlightened investors is that 'eternal vigilance' is indeed the price of 'financial liberty', and that they would be better off 'governing' their own investments without relying on a 'master' to tell them what to do.

Which is not meant as a disparagement of the instincts of the honorable brokers and wealth advisors who truly have their clients' best interests at heart. Rather, it is an observation on the degree to which they tend to drink the industry Kool-Aid (a hip pocket reference to blind loyalty regarding the mass suicide poisoning method used by the infamous Jim Jones religious cult.)

That always seems to gravitate back to the similarly blind long-term over-confidence in bullish equity market trends; with the more recent tendency to be over-positioned from that otherwise enlightened perspective that people are indeed living longer.

We have a corollary to that somewhat misguided investment axiom (such as it is) noted above, "If you have never sold, you have never actualized a profit." That is the primary reason why investors need to go to school on the perspective of the most successful trend analysts and discover two important things, no matter how hard they may be to understand and implement.

The first is the ability to identify when the major trends reverse, or for specific equity market stocks, when the trend reverses for that particular company. The second is how to use effective capital preservation exit strategies that the investor can apply no matter how optimistic their advisor might be.

Sustained optimism that is often an effort to get investors to pull money out of the FDIC guaranteed mattress to achieve higher returns is not intrinsically evil; just less than effective at times, …especially like these.

Un-Learning

Central Bankers and Treasury Officials

Speaking of being overly optimistic, and not changing tactics as markets tell you you're wrong, how about that Ben Bernanke?

One of our favorite quotes on developing an informed view is the classic broad strokes perspective from Georges Santayana, "He who does not learn the lessons of history is doomed to repeat its failures."

The problem is one of digging below the surface for the full lesson. As we have noted previous, there is a tendency to take the surface lesson and apply it in too broad a fashion; a matter of failing to distinguish between coincidence and causality. That is something Malcolm Gladwell cites as a modern psychological construct in his excellent book "The Tipping Point" as a "Fatal Attribution Error."

And the ostensible 'big picture' lesson from the monetary and economic history of the Great Depression was that the rapid drop in liquidity left banks without money to lend. And that was the proximate cause of the extensive business and banking failures that backlashed into the general economy, and destroyed consumer confidence.

And in that last phrase lies the rub. In the final analysis consumer cutbacks and rapid deleveraging were responsible for loss of velocity in the M2 Money Supply as well as sharp deterioration in commodity prices and the general downward price spiral.

Whoever had money wanted it back from the banks and were not leaving it on deposit for lending, and whoever was indebted was not a good candidate for loans once the banks became significantly concerned about the *extended future value of any assets* that could be posted as collateral. For all of the massive funds splashed about in attempts to maintain liquidity, that sure sounds awfully (in the literal sense) familiar.

As such, it was true that the banks were not adequately capitalized. And in fact the Fed was constrained by stubborn legally binding adherence to the gold standard that also prevented the creation of any additional money stock. It was not just an elective decision on the part of a dominant and inflation paranoiac New York Fed (other than a lack of desire to apply the requisite political influence to get the laws changed), which is often misunderstood.

In fact, the governments of the UK and Scandanavian countries left the gold standard quite early once the economic crisis hit, and came out the other side of the downturn much sooner and in much better shape.

Nonetheless, that lack of confidence is always the key element that must be avoided at all costs (including the risk of some distortion in some markets for a period of time) if a central bank is to properly maintain a fiat money regime.

And what was that very substantial asset of US consumers who drove the entire world economy for the last few years? (Not like you needed us to tell you...) Their home. And there is little doubt that even after two years of falling modestly, US home prices were likely still more than a bit overpriced as the credit market crisis first began to bite last summer and continued through the fall right into this year.

As we have noted on quite a few occasions, Messrs. Bernanke and Paulson were not wrong to see how things developed on a free market basis late last year, and even into the early part of this year. Yet, once home prices were obviously falling at a double digit annual rate, it was time to abandon the ideology and change course into more direct at-risk borrower relief; even if that included what some characterized as rewarding 'bad decisions.' As noted above, that didn't stop relief for Wall Street.

Throughout the entire affair there has been much official talk of how the housing market needed a good economy instead of the other way around.

There were more than a few very pointed questions during a series of Congressional hearings on why it was more effective to offset losses than at least get more aggressive about addressing the core problem. Mr. Bernanke's consistent response was, "Housing won't do well in a weak economy."

It seemingly has either still not occurred to him, or surveying extreme carnage on the financial and economic battlefield, he is now rue to admit it. (Even Mr. Greenspan was allowed a bit of time in retirement prior to falling on his sword.) The fact is that it is actually the other way around if the key is confidence.

Any address of the situation required a major shift over to house price stabilization that Messrs. Bernanke and Paulson either never understood, or were ideologically averse to pursuing.

As noted above, if it weren't so tragic for millions, it might actually be amusing that Mr. Bernanke, the Great Student of the Depression, had not realized its real lesson.

That stubbornly maintained 'static' view of everything turning out okay as long as huge piles of money were shoved at the banks, even as consumers went on strike, is now a tragedy that could have been limited to a manageable problem.

Professor Bernanke has put his stock (and all of ours to some goodly degree for that matter) in a false lesson inferred from not fully pondering the real implications of liquidity drying up in 1929-1932.

In his adamant stance that saving the banks would also save the economy (which is actually comprised of a whole series of independent operators who can choose to disengage if their confidence fails them), he has come around to failing at the one task he always felt his intellect could conquer.

As we have noted regarding his failure to cool the economy from what many of us saw as an overly exuberant (with a nod the Mr. Greenspan) credit and equity market situation once DJIA surpassed the 11,750 January 2000 previous all-time high from the Dot.Com Bubble, avoiding decisive action has come back to haunt him.

As we noted in a July 2006 letter to the FT Editor, "…its desire to be everybody's friend will actually make the Fed its own worst enemy." And that now seems to be the case both on the lack of desire to pull the punchbowl before the party got too raucous on the way up, and the inability to see the sense in applying capital to the core US home price problem on the way back down. As French fabulist Jean de La Fontaine noted centuries ago, "Our destiny is frequently met on the very paths we take to avoid it."

There is quote from Lawrence Summers back in 1991 that Bank of England MPC member David Blanchflower used in his presentation late last month that also applies to the dilemma of Mr. Bernanke not having effectively made the transition from academia to a true global financial leader. "…progress is unlikely as long as macroeconomists require the armor of a stochastic pseudo-world before doing battle with evidence from the real one."

It seems the 'received wisdom' that many took from studying 'obvious' lessons of the 1929 stock market crash devolving into the Great Depression must be 'un-learned', or significantly embellished with real world perspective the Cassandra's have wailed about for some time.

A fiat currency regime requires maintenance of confidence above other priorities, even if it means distortions in some markets. Under the circumstances, who would really have cared if US home prices were kept a bit too high for now after years of distortive government support?

As we have noted previous, in light of all of the encouragement for home ownership by folks who could barely afford them but were underwritten by the very liberal policies at Fannie Mae and Freddie Mac, 2008 just seems like an awfully odd time for the government to 'get religion' on the strict application of purist free market ideology.

Somehow it would seem more rational to assist the credit junkies in withdrawal from their heady addiction by offering them a bit of medicine along the way; much as one would allow that a heroine addict who was experiencing a grand mal seizure should be allowed some methadone.

As much as that would calm nerve endings and prevent the major heart attack or respiratory collapse for the physical addiction, it can only be hoped that it is not too late to calm the current panic seizure of the US general public with a dose of foreclosure relief.

That would seem to be the other lesson that needs to be re-learnt by the central bankers, especially the ones down at City Hall in Borrowing Binge Borough. It does not really matter how much liquidity you apply unless you also take steps to ensure confidence remains high enough to maintain the very minimum of requisite velocity necessary to avoid a crash. Which is exactly what we have had: our version of 1929.

It may well be that the lesson of 1929-1932 was not to let liquidity dry up. Yet unless the deeper lesson that confidence failing was the greater evil that contributed mightily to the liquidity problem is also absorbed, the current pain will not necessarily result in the success of any brave new regime powers-that-be envision for the future.

In fact, this gets back to the question we posed in the last *Capital Markets Observer*, courtesy of the vintage lyrics from Bob Dylan regarding:

"…what price, You have to pay to get out of, Going through all these things twice."

It is likely odd to other folks as well that the price has been exceedingly steep, yet we've not gotten out of going through anything which guarantees a better way forward than the early 1930s. Where is that nice Ms. Bair?

That does not even begin to address the follow-on problems from the massive liquidity operations. While it might seem premature to look through to the other side of the cycle, once the authorities find the means to reinvigorate the economy (as they will at some point), it does add velocity to a bowl that is filled near the brim with liquidity. Is it reasonable to imagine that none of it will come sloshing over the rim in the form of inflation? Our 10 year T-note yield target across the cycle is still up at 9.00%-9.50%. Yet that is a conversation for another time.