GREYCOURT

White Paper No. 54: Investing When Fundamentals Don’t Matter

August 2012

GREYCOURT

"The seemingly intractable investment dilemma is how to deal with markets lurching from exuberance to depression in unpredictable ways."
– Ted Lucas, Lattice Strategies

Virtually everyone in the investment business today grew up in a world where fundamentals dominated the markets. But from the collapse of Lehman Brothers in the fall of 2008 right up until today, markets have been driven not by fundamentals but by geopolitical events and central banker policies. Unless we can somehow get inside the heads of, say Ben Bernanke and Angela Merkel, we can only speculate about what's going to happen. And one thing investors should never do is speculate about unknowable things.

❖ Investment Fundamentals

By "fundamentals" we mean the common sense ideas that underpin any understanding of the investment world that we can make sense out of:

- Investors will demand – and, in general, receive – greater returns to invest in a more risky security than in a less risky security. Yet the riskiest securities – emerging markets stocks, for example – have significantly underperformed less risky securities – US large cap stocks, for example.
- Diversification reduces risk, and thoughtful diversification reduces risk faster than it reduces return. Yet as we all know, when markets have melted down virtually all sectors have moved in lockstep, leading investors to complain that "Diversification only works when you don't need it."
- Finally, hard work distinguishing value from price is how investors add value and outperform other investors. Yet active managers have overwhelmingly underperformed since 2007, and some of the best managers have underperformed the most – especially value investors in 2008.

Investors complain that they have bought assets that seemed clearly undervalued by long-term norms and have been hurt when a geopolitical event came out of nowhere. Meanwhile, other investors are eagerly buying assets that seem clearly overvalued by the same norms, but central banker policies keep prices of those assets rising.

For example, legendary investor Louis M. Bacon, founder of Moore Capital Management, recently decided to return $2 billion to his investors. According to the New York Times, Mr. Bacon "has been stumped by the current debt crisis in Europe." Said Bacon, "The political involvement [in markets] has been so extreme… What they are doing is trying to thwart natural market outcomes."[1]

White Paper No. 54: Investing When Fundamentals Don't Matter
Gregory Curtis, Chairman
August 2012

❖ Macro Events

Geopolitical events, sovereign actions and central banker policies have always been important market movers. But rarely – and certainly not in our investment lifetimes – have macro events so completely dominated markets for so long.

The problem arises because the world's developed economies are not slogging through a typical economic recession, but a full-blown financial crisis, which is a very different animal. As we know from reading Reinhart & Rogoff,[2] financial crises arise from different causes than recessions, tend to last much longer and tend to have more repercussions for the economies in crisis. The current crisis, for example, can be said to have started in the US in mid-2007 with the credit crunch, but it's still raging in Europe five years later, with no end in sight. And if we really want to take a long look back at the distortions and bubbles that led up to the crisis, note that as this paper is being written the S&P Index is hovering around 1330. But the index first hit 1330 in April of 1999, 13 long years – and a lot of breathtaking volatility – ago.

As a result, central banker intervention has been more massive, of much longer duration, and more unconventional (quantitative easing, Operation Twist) than we've ever seen before.

❖ Consequences for Investors

One issue to keep firmly in mind is that central bankers and sovereign nations aren't especially concerned about the plight of investors. They are trying to preserve the global financial system and to stimulate moribund economies, and if investors happen to be in the way, that's too bad. For example, the Fed has stated baldly that it wishes to create a mini-bubble in assets prices, presumably to increase the "animal spirits" among the public: "Our goal is to try to get the level of asset prices *above their intrinsic level*."[3] (Emphasis supplied.) Ultimately, those efforts will be in investors' interests if they are successful, but in the meantime investors are simply pawns in a very large and momentous chess game.

Sovereign and central banker interventions distort markets in many ways, but let's focus – just as an example – on the phenomenon known as "financial repression."[4] Technically, the term "financial repression" encompasses a wide variety of techniques available to sovereign nations that are designed to shift income from citizens to the sovereign. For example Reinhart and Sbrancia[5] identify the following techniques:

- Capping or controlling interest rates

- Requiring banks to hold government debt (e.g., via reserve requirements)
- Government ownership or control of banks and other financial institutions
- Capital controls

In the US, the primary technique used by the Fed has been the first of these: artificially keeping interest rates below the level of inflation. But this action has serious ramifications throughout the economy, including ramifications for investors. Here is just a sample of the kinds of distortions that occur as a result of US financial repression and which must be worked out of the system over time:

- Investors tend to estimate the relationship between risk and return by using a "building block" approach, beginning with the yield on cash and risk-free bonds. But if the yield on those instruments is being artificially reduced, risk across the market spectrum is distorted.
- Investors often look to the yield curve to estimate where the economy is headed, e.g., predicting recessions. But since the yield curve is being manipulated by the Fed, it is meaningless.
- In the corporate world, capital expenditures will be undertaken only if the discounted future value of a capital project exceeds its cost. But if the current cost of capital is artificially low, corporations will tend not to trust their discounted cash flow models and won't invest but will simply hoard cash.
- Whenever capital allocation decisions are being made by central planners (e.g., the Fed), rather than private markets, it is reasonable to assume that those decisions will be suboptimal.
- Artificially reducing interest rates dramatically increases the unfunded level of pension plans in the private and public sector.
- Sovereign nations, individual states, and even localities are tempted to over-borrow because rates seem quite low. But when rates revert to their normal levels, the stress on national, state and local budgets can be extreme.

In a broader sense, financial repression is at best unseemly and at worst immoral, as it punishes virtuous behavior – saving for retirement, e.g. – and rewards bad behavior – taking more risk than is appropriate.

Finally, nothing discourages long-term investing in the markets more than a widespread sense that those markets are being rigged. And under financial repression, investors *know* that markets are being rigged by central bankers who are suppressing interest rates.

One result of the Fed's actions has been a wholesale flight by investors from equities, even during periods when equity returns have been reasonably strong. According to the Investment Co. Institute, since 2007 $350 billion has moved out of equity mutual funds and over $1 trillion has moved into bond funds. While more recent data show some improvement in these numbers, investors remain far below where they were in the 1990s or pre-2007. Thus, the Fed's goal of encouraging investors to take more risk seems to be failing.

When longer term, more patient investors abandon the markets, those markets are characterized by much lower volume and dominance by short-term traders. It is these traders who are driving market volatility because they are trading on the basis of short-term momentum and sentiment, speculating about what central bankers and sovereigns might do.

❖ Navigating Macro-Driven Markets

Merely because markets are being driven mainly by geopolitical events and central banker policies, that doesn't necessarily mean that returns will be poor – only that markets will be especially difficult to navigate. Our most important piece of advice is to avoid the roller coaster ride provided by the frequent melt-ups and melt-downs that have characterized markets since 2007 and that are likely to continue to drive markets for some time to come.

As we know, high volatility is destructive to our capital due to the phenomenon of variance drain: the more volatile our returns, the slower the capital grows. The actual calculation of variance drain is complicated, but the effect can be easily illustrated. Imagine that you own a $1 million portfolio. In Year 1 the portfolio appreciates 50% and is now worth $1.5 million. In Year 2 the portfolio declines 40%. You may imagine that you're still ahead of the game, but in fact your portfolio is now worth only $900,000.

To take advantage of any opportunities the market provides, while avoiding the worst of the volatility, here are five recommendations:

First, play defense. We recommend remaining below target in risk assets, though not blindly so. For example, it will likely be useful to stay below target in Europe (due to the possibility of a breakup of the Eurozone) and in US small caps (where valuations are high). Valuations are more attractive in the emerging markets, but of course those markets are characterized by frequent capital flight. We recommend maintaining target or even slightly above-target allocations to US large cap stocks. Commodities have been beaten down to levels that seem reasonable on an intermediate-term basis, so we are adding to our positions opportunistically.

Second, buy quality. As noted, we like "Blue Chip" stocks (wherever they are domesticated) with clean balance sheets and global marketplaces, especially a presence in emerging market economies. As Bill Gross likes to put it, despite all its problems, the US is "the cleanest of the dirty shirts."

Third, overweight hedge. In volatile, complex markets, managers with access to more investment strategies have an advantage over managers who can only buy long. As market differentiation returns (as it has so far this year), long/short hedge fund managers are likely to find room to run. But just in case, we also recommend maintaining exposure to the more macro hedge fund strategies that held up well in 2011 but have struggled thus far in 2012.

Fourth, maintain optionality. In other words, be sure that, in the event of a severe market decline, you will have the option to take advantage of the lower prices by buying in. If you are fully invested in risk assets, your holdings will simply decline in value along with the markets.

Finally, try to remain patient. It's easy to be discouraged by market rigging, political stalemate, mind-numbing complexity and high volatility. But it's very important not to allow your risk tolerance to atrophy. If you abandon the markets you will almost surely miss the powerful upswings that are crucial to producing good long-term returns. That is what happened to so many investors who bailed out in 2008 (and in 2002, and in 1987, and in 1974…).

This paper was written by Gregory Curtis, Chairman, of Greycourt & Co, Inc. The author can be reached by phone at 412.361.0100 or by email at gcurtis@greycourt.com. *Please note that this presentation is intended to provide interested persons with an insight on the capital markets and is not intended to promote any manager or firm, nor does it intend to advertise their performance. All opinions expressed are those of Greycourt & Co., Inc. The information in this report is not intended to address the needs of any particular investor.*

---

[1] Landon Thomas Jr., "A Hedge Fund Too Big to Profit," New York Times, August 2, 2012, p. B1.

[2] Carmen M. Reinhart and Kenneth S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (2011).

[3] Cited by Adam S. Abelson, Stralem & Company Monthly Letter, July 5, 2012.

[4] The term financial repression was first used by Edward S. Shaw and Ronald I. McKinnon back in 1973. See Edward S. Shaw, *Financial Deepening in Economic Development* (1973), and Ronald I. McKinnon, *Money and Capital in Economic Development* (1973).

[5] Carmen M. Reinhart and M. Belen Sbrancia, *The Liquidation of Government Debt*, NBER Working Paper Series, available at www.nber.org/papers/w16893.