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A beef quiz, and revisited Koo

"Like a Hitchcock film. You did not need to see the blood and gore and violence – the hint of it and the menace that pervaded the office was worse."

- Theo Zemek cheerily describes the atmosphere at New Star Asset Management.

Just as there are said to be no atheists in foxholes, try finding a long-term investor during a Crash, or even amid fears of one. We extend this thesis and welcome in the New Year by means of two Buffett-related behavioural anecdotes; one from the great man himself, the other courtesy of Sanlam's Kokkie Kooyman.

From the 1997 Chairman's Letter to the shareholders of Berkshire Hathaway:

"A short quiz. If you plan to eat hamburgers throughout your life and are not a cattle producer, should you wish for higher or lower prices for beef ? Likewise, if you are going to buy a car from time to time but are not an auto manufacturer, should you prefer higher or lower car prices ? These questions, of course, answer themselves.

"But now for the final exam: if you expect to be a net saver during the next five years, should you hope for a higher or lower stock market during that period ?

"Many investors get this one wrong. Even though they are going to be net buyers of stocks for many years to come, they are elated when stock prices rise and depressed when they fall. In effect, they rejoice because prices have risen for the "hamburgers" they will soon be buying.

"This reaction makes no sense. Only those who will be sellers of equities in the near future should be happy at seeing stocks rise. Prospective purchasers should much prefer sinking prices."

There is one caveat to Mr. Buffett's otherwise excellent analogy. For those investors who are reliant upon a fixed pot of capital – call it permanent capital, if you will – and who have no means of 'topping up' that pot by way of further earnings from employment or income from other sources, then the hamburger metaphor is no longer entirely valid. Savers drawing upon a fixed pool are right to be wary of bear markets if they face the realistic possibility of outliving that capital pool. But for investors with the luxury or flexibility to add to their pool, Buffett's analogy holds.

What follows now is a thought experiment that again addresses the aspiration for long-term capital growth and how comparatively quickly that aspiration can fail upon contact with a bear market.

Imagine you had invested $10,000 in shares of Warren Buffett's legendary holding company, Berkshire Hathaway, at the end of 1971. Then imagine you (or better yet, a sibling or friend) had invested $10,000 into the S&P 500 stock index at exactly the same time. The table below shows how your investments would have fared:

Year	Value of Berkshire Hathaway holding	Value of S&P 500 holding
1971	$10,000	$10,000
1974	$5,708	$7,456
1975	$5,422	$10,229
1976	$13,392	$12,643
1991	$1,361,805	$92,940
2008	$14,387,737	$259,068

Source: Berkshire Hathaway / Sanlam Investment Management.

The raw data alone show that Buffett endured a miserable Crash. By 1974, the broad market had fallen by a quarter, but Buffett's business had lost almost half of its value. Worse still, by 1975, the S&P 500 had recovered its losses, but Berkshire was even further in the hole. Try and answer this question honestly. If you were holding Berkshire stock, and were keeping an eye on the broader market, would ***you*** have bailed ? Even if you might have not, many undoubtedly did. The subsequent returns show how bitterly the hypothetical Berkshire sellers of 1975 would have regretted their abandonment of the longer term. This may not seem like a fair comparison, given the extraordinary outperformance of the market by Buffett and Berkshire over the longer term. The point remains that (at the time) the world's most successful investor lagged the market over a four year period. If nothing else, this thought experiment suggests very strongly that assessing portfolio performance for a period as subjectively short or long as a calendar year has limited use versus the ***real*** long run. So are you a long term investor now ?

The world of "professional" economists has not acquitted itself well during the Financial Crisis. This may be because economics is a false science, and most of its practitioners are charlatans, and it may be because economists are more concerned about maximising job security by peddling conventional wisdom supportive of the banking sector than by issuing objective counsel about the state we're in. Nevertheless, some economists deserve at least a mention in despatches, and Richard Koo is among them.

Koo, chief economist of the Nomura Research Institute, argued in 'The Holy Grail of macro-economics: lessons from Japan's great recession' that it was pointless to fight the Japanese recession of the 1990s with conventional policy tools because it was not a conventional recession. Economists tend to refer to 'business cycle' recessions, where central banking tightening of monetary policy suppresses inflation following a boom. Yes, there was once a time when central

banks were actually capable of raising interest rates rather than simply cutting them. There was indeed a time when central banks actually gave a stuff about inflation, though those times are obviously long gone. In order to save banks and bankers, the rest of the economy can go hang.

Koo's point was that Japan was not suffering from a typical common-or-garden 'business cycle' recession, but rather from an economic contraction caused by balance sheet restoration – hence his phrase 'balance sheet' recession. In a 'balance sheet' recession, companies and households have amassed too much debt, and are more concerned with paying it down than with borrowing more. Amid such deleveraging, it doesn't matter how low you drive interest rates, because the vast mass of the private sector has no real interest in borrowing.

Koo was rightly sceptical about the role of quantitative easing (for want of a better phrase: money printing), a monetary experiment first made by the Bank of Japan. He called it the twenty-first century's greatest monetary non-event. His analogy was with a shopkeeper nursing a store of apples he is simply unable to shift. When he cannot sell more than 100 apples at ¥100 each, he then tries filling his shelves with 1,000 apples, and when that has no effect, adds 1,000 more.

"As long as the price remains the same, there is no reason consumer behaviour should change – sales will remain stuck at about 100 even if the shopkeeper puts 3,000 apples on display. This is essentially the story of quantitative easing, which not only failed to bring about economic recovery [in Japan], but also failed to stop asset prices from falling well into 2003."

Now Koo is back. His latest piece is rather ominously entitled 'The world in balance sheet recession' and it can be read here.

In his original book, Richard Koo makes the fair point that the Japanese government – by abandoning all fiscal restraint and amassing an extraordinary debt load – stepped in to the void left by a deleveraging private sector and managed to prevent a Depression in Japan. The point often lost by observers of Japan's "lost decade" is that it could have been so much worse if not for massive government borrowing. But the point insufficiently understood by Richard Koo this time round, we think, is that the other governments of the west no longer have the approval of the markets to expand their balance sheets further by issuing yet more debt. Japan itself may be the first truly major economy to encounter a bond market explosion. In a recent letter to investors titled 'Imminent Defaults', hedge fund manager Kyle Bass alluded to countries at risk, including

"Greece, Italy, Japan, Ireland, Iceland, Japan, Spain, Belgium, Japan, Portugal, France, and have we mentioned Japan ?"

The sobering conclusion is that there is no painless way out of our current predicament. The Keynesians would like the government stimulus bandwagon to roll on, no matter how many bodies get thrown beneath it. We incline to the Austrian perspective, which argues that there is no problem so bad that government intervention cannot make it worse. Any Austrian economist will tell government not to interfere with the market's adjustment process. As Murray Rothbard put it, in "America's Great Depression":

"The more the government intervenes to delay the market's adjustment, the longer and more gruelling the depression will be, and the more difficult will be the road to complete recovery. Government hampering aggravates and perpetuates the depression. Yet, government depression policy has always (and would have even more today) aggravated the very evils it has loudly tried to cure."

But we are investors and not policy-makers, and many of our clients are dependent on a fixed pot of capital – so the requirement for capital preservation notwithstanding an environment of acute uncertainty is all the more urgent.

No lessons have been learnt by our monetary leaders. Investors today are effectively passive spectators to a titanic battle between the (market) forces of deleveraging on one side and the increasingly desperate forces of government inflationism on the other. Fiat currency for one is rapidly becoming collateral damage amid the unfriendly fire, which is why we continue to see merit in the paper currency insurance that is gold. Yes, the gold price has fallen sharply over recent weeks, as expressed in nominal dollars (of dubious intrinsic value). But it still ended 2011 up a little over 10% from where it started. And its price has risen by, on average, 15% per annum over the past decade. Stocks (as expressed by the MSCI World Index) have, by comparison over the period, generated total annualised returns of less than 1% in nominal terms, and one dreads to think what in real terms. And it has been fairly typical, despite the strength of its rally, for gold, every year, to have incurred double-digit percentage corrections, along the way.

But gold does not form the totality of our savings and investments. Despite (or more fairly, because of) the economic and political uncertainties of our time, we also see merit in the most creditworthy and yieldy bond investments (hint: not in the supposed safe havens of the US or UK government markets, with their negative real yields and bubbly price characteristics); in high quality defensive equity investments, and in managed futures investments whose investment returns are not precisely forecastable but whose ongoing lack of correlation to traditional assets is a racing certainty. Like many we have little overarching conviction but unlike many we see little point in trying to predict the hopelessly unpredictable. As in 2011, the twelve months ahead, for us, will remain a search for safer havens and dry powder.

We wish all readers a happy and prosperous New Year !

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