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The Great Escape

We observe that in a backdrop of confusing signals, most market participants remain apprehensive as to what to do. Many would agree that our financial system is undergoing a seismic shift, but judging from their conclusions, few of them understand the nature of the tremors and even fewer are prepared to seek appropriate remedies. Mr. Scott Mather of Pimco speaks of financial repression as a "tool to redistribute wealth from creditors (citizens) to debtors (governments) to the detriment of creditors, fixed income investors and savers." But diagnosis is insufficient. Mr. Mather suggests that one should get out of risky German government bonds and buy emerging market currencies and bonds, in the hope that this paper will appreciate as these countries "nurture domestic consumption and their economies become less dependent on export demand." Despite the obnoxious economic reasoning, it seems that many folks have taken Mr. Mather's advice since the currencies of such "emerging" places have been on a tear. For the first quarter, the Polish zloty was up 10.7% against the dollar. It was followed by the Hungarian forint (10.1%), the Russian ruble (9.5%), the Mexican peso (8.85%) and so on. Even Madagascar's money variety, the once-unloved ariary, appreciated by more than 6.3%. And why not, you ask? If the European sovereigns have turned out to be a disaster and if the Japanese paper is some toilet-paper variety and if (as we all know) the US treasuries are, well, über-paper, why don't we just buy Madagascar?

The answer is that paper money means paper promises and its value is not determined according to whether it is of an *advanced* variety or of the *emerging* class. It is like horsepoop. It makes no difference if it comes from an old veteran or a young colt. Poop is poop.

"In a world of perfectly efficient markets," writes Edward Chancellor in the FT, "bond investors anticipate inflation and demand compensation for it. Governments are not able to inflate their debts away." But then he reminds us that even if we appear to be far removed from the capital controls of the Bretton Woods Era, in today's "age of free capital movement, financial repression is still possible because it is being simultaneously practiced in the world's leading financial centres." Governments everywhere have "a shared interest in maintaining rates below the level of inflation," and new regulations requiring banks to hold more government bonds also favor financial repression. "There is no escape," he concludes.

In his latest monthly commentary, the big man at Pimco, the estimable William H. Gross, shows off that he too knows what's going on. He cites the need to "recognize that investors are locked up in a financially repressive environment that reduces future returns for all financial assets," and suggests that "breaking out of that 'jail'" is nothing less than the "Great Escape." In a long and well-written essay, he describes the decades of leveraging up and the false era of growth as the result of "extending credit, lowering interest rates, expanding deficits, and deregulating." He describes how "financial assets relative to real assets outperform in such a world as wealth is brought forward and stolen from future years." He suggests that financial repression (negative real yields) will be with us for years and that one needs to think of an escape route. "You need a Great Escape to deliver in this financial repressive world," he urges. Mr. Gross favors "high quality, shorter

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duration and inflation-protected bonds; dividend paying stocks with a preference for developing over developed markets; and inflation-sensitive, supply-constrained commodity products."

The road to discovery has to start somewhere. Slowly, one at a time, people begin to recognize something is rotten. Confidence is shaken and then *boom*. Greek paper was once considered high quality even though everyone knew that the Greeks had lied and cheated their way to such standing. Frankly, I am quite sympathetic to Mr. Gross's position. In nominal terms, his own trillion-dollar bond fund is a beneficiary of monetary intervention. What does an honest man do for an encore?

Our problem is far larger and I suspect that Mr. Gross knows it. Most of all that is considered to be wealth in this world—the assets of pension funds, virtually all bank reserves and the collateral of billions in dubious assets, for a start—is nothing more than a promise to pay resting on a rather large bed of derivative instruments and without any intrinsic worth other than the criminal power of the state and its agents to loot and debase. There is inescapable irony in viewing this quest for safety in the false promises of the monetary ventriloquists of our time.

Post-escape

Thankfully, for our own investment pursuit, the idea of a *Great Escape* is a thing of the past. In Steve McQueen-fashion, we started digging our tunnel long ago and we've come out of the other end unscathed. If you've been around for a while, you understand. Yet, what is perplexing about escape is that the escaping part is only the beginning. More crucially, one must know where to go *after* he escapes. Steve McQueen didn't. He rode aimlessly away only to be caught and brought back. At the risk of making too much of this metaphor (it was Mr. Gross's idea after all), knowing where to go is what preoccupies us more than what's happening at the "jail" we left behind.

We have spent most of the dark winter days on the endless task of thinking and re-thinking what is independence, scarcity and permanence—for every single asset and every single idea that contributes or could contribute to our collection. We have looked at business risks in terms of factors such as increasing cost inputs, decreasing demand, labor constraints, competitive constraints and capital cost issues. We continue to add, but ever so slowly, to some of our existing participations, even mindful that the risk of lower asset prices is not misplaced. As the 2011 results have began to trickle in, we aim to further enhance our judgment along the objectives of acquiring and holding certain and unambiguous substance. While we don't know the future nor claim any ability in forecasting, we can be certain of a few things and can have some confidence in a few more.

My thoughts on value include not merely the price of an asset being favorable for acquisition but, moreover, the desirability of such specific investment notwithstanding its price.

Not far from our office, lying right on the edge of the beautiful lake of Zurich, in a most desirable part of the city, there is a grand and imposing 19th-century office building. As it rarely happens with such buildings in Switzerland, some years ago it went up for sale. A friend of mine inquired about buying it. He was quickly outbid by a mysterious buyer who paid what seemed to be an exorbitant price—one that implied a 2.4% yield. "That's just way too much," sighed my learned friend. Fast forward: not long ago, I stumbled on one of our mysterious buyer's advisers. We were seated together at a dinner function. Slowly, and very tactfully, I brought up the subject. My curiosity was only technical. What was the approach to valuation? After all, a man who can pay a nine-figure sum in cash is no dummy. The mysterious buyer was a private investor of whom I have known for years and whose skill and views I have long admired. The young man, an employee of the family office, spoke briefly about the scarcity element (of course), the irreplaceability and desirability (OK) and the unusual nature of extraordinary assets (Understood). But his real answer was astonishing. "It's easier to see our approach if you look at it over a hundred year time span," he said. *A hundred years?*

Admittedly, the story is not so relevant to our pursuit. After all, our capital is variable and our assets belong not to one family with long time preferences, but to many shareholders with diverse needs. I bring it up only insofar as it illustrates something with which I have been preoccupied for many months now: the essence of permanence and its value. My thoughts on value include not merely the price of an asset being favorable for acquisition but, moreover, the desirability of such specific investment notwithstanding its price. Despite the volumes of scholarship in the field of investment management, one fails to satiate his understanding as to *what is* something so simple as an investment. Perhaps this is because we have sought to focus on quantity instead of quality both in thinking and in scholarship. Perhaps it is on account of the pseudo-intellectualism with which we have dressed our banal quest for *making money*. Or, it is merely a manifestation of a preference for financial wealth at any cost—itself the product of a credit-driven instead of a savings-driven world. Regardless of the reasons, I have developed somewhat of an attraction to the idea of multi-generational capital accumulation that seems to be so strange to our financial culture.

Misplaced euphoria and other distractions

You will not be surprised to read the list of the best performing financial assets of the first quarter: European bank shares, emerging market currencies, junk bonds and peripheral European government bonds. Stock markets rallied on little volume, not on account of profits but because of expectations of more money printing. The temporary patching up of the hopeless Greek condition and the billions upon billions of liquidity injections in the banking system have created a euphoria and a hope of better things to come. Experts of all sorts are proclaiming that the long-sought recovery has been successfully engineered and it is just around the corner.

> The distinction between what is productive and what is not has been blurred since the illusion of wealth has been diverted into consumption while other parts of the real economy stagnated.

American investors in particular are addicted to more quantitative easing—a form of "monetary morphine" according to Anthony Crescenzi, another Pimco analyst—they crave it and demand it. Back in October of 2011, Mr. Bernanke told us, officially, that the purpose of QE1 and QE2 was to raise asset prices—an illusion of wealth. What Mr. Bernanke had in mind was higher stock and bond prices. That's good. On the other hand, speculating on higher energy and commodity prices is bad. The idea is that speculating in stocks is good because it leads people to feel rich and spend which stimulates the economy. On the other hand, speculating in oil or commodities is evil because it produces inflation. Mo' money please.

We are of the view that the financial setting in which we find ourselves in early 2012 is, in fact, worse than ever. Anything to the contrary is misplaced euphoria and a needless distraction.

General impairment

The "recovery" that our dear leaders so desperately seek to engineer is not only elusive but also temporary, for it must be seen within the context of the consequences of the many years of debt-fueled expansion that have enabled us to consume our capital and count it as prosperity.

We are facing the consequences of having destroyed the foundations of the real economy for the sake of a grand socialist experiment. Whatever producers are left in our world are unable to continue providing for the politically-connected parasitic class. Confiscating their assets will not be enough either. The system must collapse under its own weight before genuine economic recovery can take place. There are no other solutions.

Honestly, the investment implications are daunting. Those who have relied for years on higher asset prices to finance future obligations are finding themselves in deep trouble. The ideas of modeling P/E ratios, GDP, and forward earnings to predict future stock valuations have already failed catastrophically. After all, the wealth created over the past 30 years was in stocks themselves and not in earnings. The credit-fueled financialization of the economy served as an incentive for more financial speculation at the expense of productive investment. Frankly, the distinction between what is productive and what is not has also been blurred since the illusion of wealth has been diverted into consumption while other parts of the real economy stagnated, and also because genuine income has not flowed to savers but to banks and other financial intermediaries.

The general impairment in honest economic calculation is made even more complicated on account of the political expediency that shapes all financial and economic events. Most investors underestimate political risk if they even understand it at all. We often read about official manipulation in the prices of precious metals but fail to see the encroachment and intervention of governments in all aspects of the world economy such as bonds, foreign exchange, the pricing of default risks, increasing regulation, the ensuing regulatory uncertainty and so on. All these interventions are political in nature. The good news is that if such manipulations are to remain effective, their complexity and breadth must continually increase. That is just not possible.

"What really broke Germany was the constant taking of the soft political option in respect of money," writes Adam Ferguson in his seminal work on the Weimar era collapse, *When Money Dies*. Someday the same may be said of America, China, Japan and the Eurozone.

The impairment in honest economic calculation and activity about which I write can be easily seen when we account for the private sector's reluctance to invest. The nature of this political uncertainty compounds such impairment.

Furthermore, by not having allowed banks to go bankrupt so as to cleanse out of the system those who failed, what we have left even among capable bankers has been rendered impotent. Between the suffocating compliance rules and the penurious interest rate spreads, no room is left for channeling honest savings to honest business activity. Banking, as our forefathers knew it, has become a historical curiosity.

In light of such massive impairment we are led to conclude that statism and interventionism do not work. Unfortunately, our culture and our thinking is dominated by political intervention as a means of improving the social order. And this, I am afraid, is unlikely to change any time soon. Our post-escape world is full of challenges demanding clarity in purpose, honest appraisal and a suitable time preference.

During a recent trip to Amsterdam, I stumbled on an old bookstore with creaking floors and several floors jammed with the kind of books that have long been forgotten. Among several finds, and for a mere five euros, I walked out with a 200-year old copy of John Bunyan's 1678 classic *The Pilgrim's Progress*. According to the Oxford English Dictionary, "pilgrim" is a 13th-century word that, it seems to me, we can all identify with: "a stranger," "from abroad," "on a journey."

So, as an inspiration for your journey, I leave you with the this little verse from Bunyan's classic work:

The hill, though high, I covet to ascend,
The difficulty will not me offend:
For I perceive the way to life lies here.
Come, pluck up heart, let's neither faint nor fear;
Better, though difficult, the right way to go,
Than wrong, though easy, where the end is woe.

We read

Having the management of a company to tell you about their "long-term" plan or strategy is, at best, a complete waste of time. I was at a meeting once to hear Herb Kelleher, the colorful founder of Southwest Airlines. He was asked about his company's long-term plan. He said "Oh, yes, we do have a long-term plan around here: It's called 'doing things.'"

I am happy to know that we are not alone in our distaste for corporate rubbish. Jean-Marie Eveillard has similar feelings: "Most of the time, it's a bunch of nonsense. Running any business is mostly a matter of trying to see and seize opportunities. It's not a matter of having a long-term plan. If it were a matter of having a long-term plan, the Soviet Union would not have dissolved."

In the same interview, which was published in *Value Investing with the Masters* by Kirk Kazanjian, Eveillard speaks about why people fail in the investment process. "The great majority of individuals," he says, "if left to their own devices in terms of investing, will do the wrong thing at the wrong time … they don't have a basic understanding of the rules of investing. A great number who invest cannot read a balance sheet, but it's less a lack of technical knowledge, because that's not very difficult to acquire. It's more a failure of character or intellect or both."

Character. Oh, yes. Meaning the failure to have a sense of values for oneself.

I have not read the book but have been told that the Eveillard interview alone is a treasure.

"But though we all strenuously maintain our anxiety to get rid of prejudices, the real reason most of us have them is that we do not want to get rid of them. We are all willing to get rid of prejudice in the abstract. But when someone troubles himself to point out any particular concrete prejudice of ours we defend it and cling to it like a dog to his bone. The only way we can get rid of this desire to cling to our prejudices, is thoroughly to convince ourselves of the superiority of the truth; to leave not the slightest doubt in our own minds as to the value of looking with perfect indifference on all questions; to see that this is more advantageous than believing in that opinion which would benefit us most if true, more important than 'being consistent,' more to be cherished than the comfortable feeling of certainty...

"The distinguishing mark of the great thinkers of the ages was their comparative freedom from the prejudices of their time and community. In order to avoid these prejudices one must be constantly and uncompromisingly sounding his own opinions. Eternal vigilance is the price of an open mind."

—Henry Hazlitt, Thinking as a Science *(1916)*

Modern experts extol the virtues of computers and digital content as the centerpiece in education. In your editor's view, not only does this mean inflating costs but it also contributes to a considerable loss of humanity. An iPad for every kid could well improve their computer skills (not to speak of Apple's earnings) but will do nothing in giving them thinking skills. Like all of the pre-1960s generation among you, my school classroom consisted of wooden desks, a blackboard with white chalk and a couple of maps on the wall. No audio visuals, no computers and no gimmicks. Instead, what my classrooms did have was real teachers—the non "education" specialists. These were teachers who knew literature, mathematics, history and geography. The basics in instruction were memory skills, thinking skills, language skills and, later on, vast amounts of reading. iPads are not only useless but also a grand distraction which is in essence the character of modern pedagogy: It inhibits the development of any ability for critical thinking, facilitating instead only irrelevant trivia, fragmentary knowledge, phony and superficial socialization, amusement and the molding of future zombie-voters for whom the state is the master. If the government can educate our children well, where has the Post Office gone wrong? So, next time you hear such expert talk about what government ought to do about education, think of H.L. Mencken: "The kind of man who wants the government to adopt and enforce his ideas is always the kind of man whose ideas are idiotic."

In a recent interview with the Austrian newspaper *Wiener Zeitung*, the inimitable Hans-Hermann Hoppe, a one-man nuclear armada, spares no room for hedging about. "Capitalism" he says, "means private property and production. All achievements of civilisation are based on capitalism. Governments own property that they have not produced themselves. Such property is based on taxes and expropriation. Governments do not contribute to civilisation, they are rather parasites of civilisation. We have to be afraid of statism."

Explaining the superiority of any system that embraces freedom of contract, he says: "The voluntary participation of the employee indicated that he is satisfied with the employment contract. Nobody prevents him from becoming a capitalist (becoming self-employed). The worker agrees to a particular compensation. No consumer is forced to buy products at the prices asked by capitalists. In contrast to these voluntary contracts, the government exploits its citizens because the relationship is involuntary. The citizens are forced to pay taxes even if they do not agree with the government's services."

And finally, responding to the marvel that is unhindered capitalism, he says: "Competition regulates itself. The existence of profits indicates that consumer demands have been satisfied. In a competitive environment, enterpreneurs always have to try to decrease costs, which benefits the consumers. Competition is the best guarantee that the market is fair."

2012 being a political year in many places, if you can stand to have your entire political worldview turned upside-down—and acquire enormous understanding in the process—we suggest that you read Hoppe's *Democracy: The God that failed*, also available in German as *Demokratie: Der Gott, der keiner ist*.

Read the entire Wiener Zeiting interview here (in German): http://tinyurl.com/ej-hoppe.

The most insidious form of tax—the kind that most people ignore but one that is most destructive—is inflation. But it also happens to be the only tool in the hands of authorities that would allow them to extinguish the trillions of accumulated debt. Surely at the expense of savers—the few of them that are left. Bloomberg's Caroline Baum is right on the mark.

Read her article here: http://tinyurl.com/ej-baum.

For more than 20 years now, James Grant, the well-known editor of *Grant's Interest Rate Observer*, has been an intellectual companion of sorts and our favorite financial historian. It's not just his ideas that make one think. He also serves them with delicious linguistic skill reminiscent of the best newspaper men of times past. He was recently invited to speak (of all places) at the Federal Reserve Bank of New York. He gave them, well, really, a lecture. I mean, a real lecture. How's this for a start: "In the not quite

100 years since the founding of your institution, America has exchanged central banking for a kind of central planning and the gold standard for what I call the PhD standard. I regret the changes and will propose reforms, or, I suppose, re-reforms, as my program is very much in accord with that of the founders of this institution. Have you ever read the Federal Reserve Act?"

Want a little package of irony, scorn, and lessons in history and economics packaged in two sentences? Here he talks to them about the dollar: "One can think of the original Federal Reserve note as a kind of derivative. It derived its value chiefly from gold, into which it was lawfully exchangeable. Now that the Federal Reserve note is exchangeable into nothing except small change, it is a derivative without an underlier. Or, at a stretch, one might say it is a derivative that secures its value from the wisdom of Congress and the foresight and judgment of the monetary scholars at the Federal Reserve. Either way, we would seem to be in dangerous, uncharted waters."

The folks at Grant's Publishing have graciously made this speech available to non-subcscribers as well. *Find it here: http://www.tinyurl.com/ej-grants.*

It's about the law, Senator!

By Otto von Schwamendingen

"No presidential aspirant has ever had such an exotic financial portfolio," suggested US Senator Dick Durbin recently in reference to reports that US presidential candidate Mitt Romney once had a bank account in Switzerland. As if his standing is insufficient (and it is), Mr. Durbin solicited confirmation from Mr. Cherry Coke-breath from Omaha: "I asked Warren Buffet in a meeting we had recently, 'Have you ever had a Swiss bank account?' He said, 'No, there are plenty of good banks in the United States.'" And if the musings of the man from Omaha are not enough to persuade you, Mr. Durbin went straight to the man on the street. "So I started asking people: 'Why do you have Swiss bank account?' One, you believe the Swiss Franc is a stronger currency than the United States dollar. And that is apparently the decision the Romney family made during the Bush presidency. And secondly, you want to conceal something. You want to hide something. Why would you have a Swiss bank account instead of one in the United States? I would like to … ask the press to really press some of these questions, the obvious questions. When is the last time a presidential candidate for the United States had a Swiss bank account? I think the answer is never."

I am irked even as I expect nothing intelligent from anyone holding political office. I am irked not only on account of the sheer banality of what goes for news but equally as much for the utter ignorance, pompousness, hypocrisy and disrespect. Does not Mr. Romney or any other person have the right to dispose their own property in a manner that suits them? Is it not his property? If you have the right to exchange your money for a Japanese television or a German car or Italian shoes or bananas from Honduras, why is it not any different that one chooses to have a bank account in Switzerland, or London or Istanbul for that matter? If you have the right to buy a condo in Puerto Vallarta, why not the right to have a bank account in Bangkok? And why is it that Switzerland irritates so many people? Why not Monte Carlo, Hong Kong, Singapore, Jersey, London or even New York?

Let's be fair. Swiss banking became famous not on account of one having "something to hide" as much for its sheer and inimitable skill (yet unknown in most lands), efficiency, superb organization and, yes, a system of law that respects and protects private property and private contracts. One is at a loss as to why America (among others) has drawn its sword against Switzerland alone, while their citizens are free to bank in Asia and other so-called havens in Europe and elsewhere. In my own view, the attack on Switzerland is solely an attack on its legal traditions. Very sadly, most Swiss people don't understand the nature of this attack, either. Yes, Mr. Durbin, the Swiss view a bank account like you view your underwear drawer. You may have nothing to hide in there but it isn't anyone else's business. It is your private property. Since you are a US Senator, we excuse you for knowing next to nothing about the law—particularly as it concerns property. And thus, we can see why you see it as "exotic" if only on account of the fact that the law in Switzerland recognizes and protects the right of an individual to have ownership over his own property without the meddling of larcenous nincompoops like you. This must surely be an "exotic" idea to a politician from Chicago, no?