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On measuring the unmeasurable

In the course of our lives, the passing of a year is an occasion to celebrate, drink a glass of champagne and exchange good wishes. Insofar as we all are economic agents, whether as individuals, families or as fiduciaries for a legal entity, it is also a time to reckon our economic results for the prior period.

We make such calculations chiefly in terms of money. We calculate, for example, how much we must pay in taxes to our overlords and how we should allocate any profits we have earned. Money calculations are also helpful in planning for our future expenditures. Let us then define this important and valuable annual exercise as *money accounting*. For most people, this is all that is necessary as 2012 becomes 2013.

However, while the exercise is necessary, it is not sufficient. The main reason is that money accounting is based on money prices, and prices are not values. Complicating matters further is that the money in which we express our price measurements is not a commodity good. In other words, the money we use is not something that is fundamentally scarce. So, our money accounting exercise, while mathematically correct, cannot result in the measurement of value. It gives us answers which may be correct by convention but are definitely imaginary since the money standard we use is itself imaginary.

To be sure, we are not against money accounting or accounting standards. We must use something if only on account of order, not to speak of legal obligation. But it is also very insufficient, because if we are to fully rely on such widely accepted yet nevertheless imaginary numbers for the purpose of our future planning without understanding their limitations, we are certain to be disappointed at some future date.

And so, as custodians of scarce savings and wealth, the passing of a year must also give us pause to consider the *true value* of our capital. That is, the quantity of purchasing power we possess and the amount of productive wealth that we command. Let us distinguish this from *money accounting* and call it *value accounting*. Here we must reckon such savings and their imputed value as a function of scarcity, permanence, earning power and many other factors to which we give significance as responsible stewards.

You recognize immediately that the terms of such value accounting are our own. There are no accounting standards and no rules for reckoning debits and credits, for value accounting is the unique product of the person doing the valuing. He has the freedom to assign greater weight to certain attributes he considers desirable and less weight to others, notwithstanding the money prices with which they are associated in the money accounting exercise. The rules we employ are simply our own. They are motivated and inspired by a set of ideas which are our own, and which we hold important irrespective of how others may think. Since the nature of such ideas can be very different, one person's value accounting is different from someone else's.

In a market economy, that is, a capitalistic economy, prices signal scarcity which helps us determine which investment should be made and in what quantity. The market for money, securities or goods in general is the meeting point and center around which the activities of buyers and sellers converge. The market rewards those who produce the most desirable goods at the best prices and punishes those who do not. Furthermore, the market economy is sovereign insofar as it forces all economic agents to adjust their self-interested activity so that it is in the self-interest of other agents to transact. In other words, the market requires and rewards social cooperation. This is an axiomatic principle in economics.

It follows therefore that to the extent that the state interferes with such voluntary cooperation, whether by imposing arbitrary interest rates, controls, regulations, or by offering subsidies and a myriad other interventions, the resulting prices are

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different from those that the market economy would have discovered on its own. The end result is that such prices are no longer reliable signals of scarcity. False and distorted like a carnival hall of mirrors, they now signal something else, and no one is quite sure what.

Yet, despite it all, the market is still supreme because socialism, social engineering, central planning, do-gooding—call it what you will—simply cannot succeed in its desire to banish scarcity, self-interest and the need for social cooperation. Thus, price manipulators can win battles but not wars. We may not know when, but ultimately, and at a timing of its own, scarcity will reassert itself as the market will reassert its sovereignty. This process will destroy the falsehood and also, we fear, impoverish the imprudent masses.

In the meantime, such problems do not impede prudent entrepreneurs and capitalists from making their own individual value calculations. In the face of these difficulties, we wish to be such entrepreneurs and we wish to use our capital to invest in those of a similar mind.

> People do things better when they are owners and when they love their business more than they love the pursuit of money.

So, how ought we to go about making our individual value calculations? What are the factors that ought to be considered? And what is the nature of "value"? These are the questions which kept us occupied over months of reflection over the course of 2012. The difficulty lay in trying to reconcile the notions of value as used in modern investment practice (which seems to equate mere cheapness with value) against our own ideas of subjective value and the components that contribute to our subjective assessment.

The result of our quest in understanding was neither tangible nor formulaic. You would be bored with the details. We pondered the notions of resilience (permanence), scarcity, independence and their "values" to us, and we reflected on the extent to which value could be derived as a function of price. But one conclusion we thought may be worthy of sharing was the need to correctly reckon the *character* of those who are in charge of the enterprises in which we invest. Of course, *character* is nowhere to be found in the financial statements. The accountant bristles at the idea of quantifying something so wishy-washy. But is anything more important? We dare say we could find an analyst somewhere who could build a spreadsheet to model it. We might even find one who believed in the exercise. But such a model would be as useful as those purporting to measure "risk". That is to say, unless only if ignored.

One might think our insistence on a variable so fundamentally unquantifiable would leave us groping around in the dark somewhat. It doesn't. Like so much that we care about, a subjective judgment over things we cannot know for sure is all we are ever able to do.

This thinking about value gave rise to a clearer realization that many of our holdings did not fit the subjective tests to which we measured them. We owned a number of things that were merely cheap and we owned a number of things managed by teams that did not pass the test of character. We have simply sold them. Just like that.

There was one wonderful lesson learned in our value quest. It may sound obvious but either we have been very slow, or the full extent of its implications are subtle. We discovered that people do things better when they are owners and when they love their business more than they love the pursuit of money. We examined the record of family-controlled companies (but not necessarily managed by family members) and the manner in which they quietly pursue what is permanent while avoiding large errors in judgment. We witnessed the manner in which such companies eschew short-term results for the purpose of sowing seeds for another generation. And how they are generally frugal whether in good or bad times. We witnessed the record of their distaste for growth through acquisitions and reorganizations, their aversion to debt, their diversification, rates of reinvestment, accounting clarity and their ability to attract and retain talent. They operate as a family business, but they are not. They respect their minority shareholders, they have better and more meaningful relationships with their employees, suppliers and customers and they are focused on what they do. And they do it well.

Over the last few months, our discussions with a few of the CEOs who run such companies have given rise to an appreciation for their complete disinterest in all things financial and focus on where their focus should be. Great entrepreneurs are still alive and well in our world. To recognize them one ought first to stop reading the cheap opinions expressed by experts in the back pages of the financial press or listening to the pronouncements of central bankers, politicians and other ignoramuses. It's much more fun to talk to those who produce and create—often in the face of considerable obstacles and always in a world lurking with substantial unknowns.

And so, we seek not to forecast next year's earnings, or the P/E multiple they will be accorded by the masses. Our interest is in acquiring and nurturing a business portfolio of outstanding capitalists where *we* get to define what "outstanding" really means.

This essay is an edited excerpt from the 2012 Annual letter to the shareholders of Edelweiss Holdings Ltd.

We read

In a recent illuminating essay about the hows and whys of gold demand and supply and their impact on prices, our friend Robert Blumen upsets all that we think we know—most of which a habit of being attracted to short and simple answers:

"The financial media commonly reports that buying is the cause of the price going up. Stories in the financial media usually report only one side or the other side of the market. For example, an increasing number of small investors buying coins is often cited as the cause of gold price strength. However, the same story could equally well have been written as a bearish report about the increasing number of investors willing to sell their coins. Either story would be true, at least from a quantitative standpoint and both would be wrong in attributing the movement in the gold price to one side of the market only.

"If the reporter accurately described a large volume of coin buying and an equal volume of coin selling, then what conclusion about the price should the reporter draw? Exactly none. Buying as such is not the cause of the higher gold price, nor is selling the cause of price declines. If buying could take place without selling or selling without buying, then one or the other could be an independent cause of price moves. But neither can occur without the other. Buying and selling occur always in equal quantities, and, at the same time. For every purchase of gold by a buyer, an equal quantity is sold by the seller. The quantity of buying, which is always the same as the quantity of selling, is not the cause of the gold price. …

"The fundamentals of gold are the current purchasing power of money; expectations about the future purchasing power of money; the growth rates of various national money supplies; the volume of bad debts in the system; expected growth rates of bad debts; the attractiveness of other available investments; and the investor's preference for consumption rather than investment. These factors do not act directly on the gold price. Instead, they are focused through the prism of investor preferences, which are not measurable. The price is the ultimate measurement of how investors view these factors. The paradox of gold is that which drives the price cannot be measured, that which can be measured does not drive the price."

—Robert Blumen, "Misunderstanding Gold Demand," http://tinyurl.com/ej-blumen.

From the *Economic Times* of India (23 January): "Less than a year after the government doubled the import duty on gold from 2% to 4%, the duty was again hiked to 6% on Monday. The hike is part of a package of measures that includes allowing gold exchange-traded funds (ETFs) to deposit physical gold with banks and modifications in banks' gold-deposit schemes to make gold a less attractive asset. It comes in response to growing fears that continued import of gold would worsen a fast-deteriorating current account deficit and imperil the country's macroeconomic stability. After oil, gold is the second-largest component of our import bill—though a distant second—and was major contributor to the record current account deficit of 5.4% of GDP in the July-September quarter.

"The underlying rationale is to encourage investors to put their idle gold in circulation and, thereby, reduce the demand for gold. The problem is *the government is once again treating the symptom, not the disease. Rising demand for gold is a manifestation of people's loss of faith in financial instruments as a consequence of high inflation as well as heightened uncertainty.* In such a scenario, gold is seen as the natural safe haven. Far from discouraging consumption, higher import duties will only encourage smuggling. The only long-term sustainable solution is to restore people's faith in financial instruments by curbing inflation…" *Emphasis ours.*

"Traveling with Lu [Ludwig von Mises] meant for me to take a private course in history and art. His intellectual curiosity was boundless: what he had not known before, he had to dive into. But he never consulted a Baedeker or a Fodor, these things he knew. The only guide he ever referred to was the Guide Michelin, for he was a great lover of good French cuisine. …

"Other [than mountain climbing] sports did not mean much to him. He played tennis—always with a trainer—but without enthusiasm. Once I watched him. When the ball was easy for him to reach, he returned it, otherwise he would not bother. When I asked him: 'Why don't you put a little effort into your game?' He replied, 'Why should I? The fate of the ball does not interest me.'"

—*Margrit von Mises,* My Years with Ludwig von Mises *(1976)*

It isn't often that a philosopher writes on the subject of bullshit. "One of the most salient features of our culture is that there is so much bullshit. Everyone knows this. Each of us contributes his share." That's how he starts. So, we went on reading. Here are some excerpts:

"Bullshit is unavoidable whenever circumstances require someone to talk without knowing what he is talking about. Thus the production of bullshit is stimulated whenever a person's obligations or opportunities to speak about some topic are more excessive than his knowledge of the facts that are relevant to that topic. This discrepancy is common in public life, where people are frequently impelled—whether by their own propensities or by the demands of others—to speak extensively about matters of which they are to some degree ignorant. Closely related instances arise from the widespread conviction that it is the responsibility of a citizen in a democracy to have opinions about everything, or at least everything that pertains to the conduct of his country's affairs. The lack of any significant connection between a person's opinions and his apprehension of reality will be even more severe, needless to say, for someone who believes it his responsibility, as a conscientious moral agent, to evaluate events and conditions in all parts of the world.

"The contemporary proliferation of bullshit also has deeper sources, in various forms of skepticism which deny that we can have any reliable access to an objective reality and which therefore reject the possibility of knowing how things truly are. These "anti-realist" doctrines undermine confidence in the value of disinterested efforts to determine what is true and what is false, and even in the intelligibility of the notion of objective inquiry. One response to this loss of confidence has been a retreat from the discipline required by dedication to the ideal of *correctness* to a quite different sort of discipline, which is imposed by pursuit of an alternative ideal of *sincerity*. Rather than seeking primarily to arrive at accurate representations of a common world, the individual turns toward trying to provide honest representations of himself. Convinced that reality has no inherent nature, which he might hope to identify as the truth about things, he devotes himself to being true to his own nature. It is as though he decides that since it makes no sense to try to be true to the facts, he must therefore try instead to be true to himself.

"But it is preposterous to imagine that we ourselves are determinate, and hence susceptible both to correct and to incorrect descriptions, while supposing that the ascription of determinacy to anything else has been exposed as a mistake. As conscious beings, we exist only in response to other things, and we cannot know ourselves at all without knowing them. Moreover, there is nothing in theory, and certainly nothing in experience, to support the extraordinary judgment that it is the truth about himself that is the easiest for a person to know. Facts about ourselves are not peculiarly solid and resistant to skeptical dissolution. Our natures are, indeed, elusively insubstantial—notoriously less stable and less inherent than the natures of other things. And insofar as this is the case, sincerity itself is bullshit."

—Harry Frankfurt, "On Bullshit," http://tinyurl.com/ej-bullshit (hat tip: JE).

Generally we shy away from religious observations except in those rare instances when religious men interfere in earthly matters about which they choose to remain ignorant. In his New Year's message, Pope Benedict said he hoped 2013 would be a year of peace and that the world was under threat from unbridled capitalism, terrorism and criminality. He also denounced "the prevalence of a selfish and individualistic mindset which also finds expression in an unregulated capitalism, various forms of terrorism and criminality." Wow… capitalism, criminality and terrorism in the same sentence? Perhaps we should not be surprised. He has a long history of such rantings. Ratzinger apologists (here and here) eagerly explain that what he means is quite different from what he says. Maybe. On the other hand, the church has long history of disdain toward private capital and free markets. The last thing we all need is to replace the present state intervention with a new ecclesiastical one. It seems reasonable to us that in an age of utter spiritual bankruptcy, the church would be better served if it focused its sole attention on teaching the Bible and engaging in charity.

"I took part in victimising innocent, good people. It was institutionalised bullying and scapegoating, and I couldn't see it because everything about the regime was good for me and I felt I was part of a movement for human progress, freedom and happiness. I wasn't feeling what happened to other people. It's a kind of corruption, exactly the kind of corruption that ruins the whole thing.

"I should have taken the side of the people fighting for the right to speak and have different opinions. I should have quit. Instead I continued to let these things be done in my name. I couldn't get down off that high horse. There was too much glory and glamour. I believed I was part of history. I couldn't let it go. That's what you get with ideology and power. You learn to harden your heart in the name of the wonderful new world you're building. Once you do that, you do all kinds of things. I did."

—Sid Rittenberg, in an interview with the FT. Rittenberg, an American, was Mao's right hand man during the Cultural Revolution. Read the whole story: http://tinyurl.com/ej-rittenberg.

How long before the state takes over all private pensions? Some think that in the interest of providing fairness—the rich after all have larger pensions than the poor—all private pensions should be taken over by government in exchange for government-guaranteed retirement provisions. After all, what good is a democracy if 51% can't vote to eat the 49%? As the parasitic class grows, so will the calls for "retirement fairness." In America, it's already started.

Read about it here: http://tinyurl.com/ej-pensions.

From time to time, we read the pages of *Pravda*—once the mouthpiece of the Central Committee of the USSR, now a similar instrument for the current administration. The 11 November 2012 issue contains a guest editorial from which we quote here: "Putin in 2009 outlined his strategy for economic success. Alas, poor Obama did the opposite but nevertheless was re-elected. Bye, bye Miss American Pie. The Communists have won in America with Obama but failed miserably in Russia with Zyuganov who only received 17% of the vote. Vladimir Putin was re-elected as President keeping the NWO order out of Russia while America continues to repeat the Soviet mistake. ... He is a Communist without question promoting the Communist Manifesto without calling it so. How shrewd he is in America. His cult of personality mesmerizes those who cannot go beyond their ignorance. They will continue to follow him like those fools who still praise Lenin and Stalin in Russia. Obama's fools and Stalin's fools share the same drink of illusion."

Read the article here: http://tinyurl.com/ej-pravda.

"The volume of gold is not important. Instead it is the value that is ascribed to this gold that is important. A zero can easily be added to a paper bill to change its value; similarly it can be added to the value of an ounce of gold. Absolute values are in fact unimportant. As we have already asserted, gold is infinitely divisible. Does it matter that a paper bill is backed by a gram or a kilogram of gold? Theoretically it shouldn't matter in our view."

—Daniel Brebner and Xiao Fu, Deutsche Bank, 18 Sept 2012.

As a society, we have eaten our capital and have become "an economy based not just on consumption of all net income but debt-based consumption is an economy devoid of savings, i.e. capital to invest in productive assets." The end result? "An economy without capital is lacking a key component of classic capitalism." So writes Charles Hugh Smith in a thoughtful article about the failure of austerity—well, at least in places where they have pretended austerity. "We have created an economy," he writes, "with an extremely high cost-basis, and as a result it is brittle, fragile and vulnerable." He describes five reasons why things are "falling apart": debt and financialization; crony capitalism and the elimination of accountability; diminishing returns; centralization; and the technological, financial and demographic changes in our economy.

True enough, but Mr. Smith's article doesn't ask exactly why it is that all of these conditions just happen to exist at once. Perhaps all such "reasons" are merely symptoms—they are. Rightfully, he explains the economy as a "complex system." But then he suggests that "if we want sustainable prosperity rather than collapse, we must embrace a new model that is Decentralized, Adaptive, Transparent and Accountable (DATA)." Bullshit. Let's fix the money, Mr. Smith. Honest money means ability to calculate, to save, accumulate, exchange, succeed, fail, produce and consume. You can't make laws for honesty and good behavior. The free market can do this on its own.

Read the article here: http://tinyurl.com/ej-smith1.

Sense and nonsense

- "There's nothing I can do—the checks come in every day, and I have to invest it."
  —Anonymous long-only bond fund manager

- "Thousands of experts study overbought indicators, oversold indicators, head-and-shoulder patterns, put-call ratios, the Fed's policy on money supply, foreign investment, the movement of the constellations through the heavens, and the moss on oak trees, and they can't predict markets with any useful consistency, any more than the gizzard squeezers could tell the Roman emperors when the Huns would attack."
  —Peter Lynch

- "I know you believe you understand what you think I said. But I am not sure you realize that what you heard is not what I meant."
  —Anonymous

- "This is a country where there is no growth, the cost of labor is very high, and when entrepreneurs succeed they are criticized for exploiting their workers."
  —Jean-Gil Boitouzet, founder of Bourse Direct, speaking to the FT about the current political climate in France

- "It is hard to make predictions, especially about the future."
  —Yogi Berra

- "The world economy has, over the past century, morphed into a highly integrated, government dominated system guided by conventional wisdom (group think) … The self-reliant, individualism of the free market has been left behind in favor of a 'new age' of coddled consumerism. Culturally this represents a very powerful force in our view, one which minimizes creative options/solutions to economic impasses."
  —Daniel Brebner and Xiao Fu, Deutsche Bank, 18 Sept 2012

- "The surest sign that intelligent life exists elsewhere in the universe is that none of it has contacted us."
  —Anonymous

- "It was a very frustrating class. Although he used equations to describe his solutions, he never really solved his equations. We were asked to believe certain fundamental principles that couldn't be proven. It was more of a religion class than a science class."
  —Thomas Massie, US Representative (R-Kentucky), describing his macroeconomics class under Paul Krugman at MIT

- "A claim for equality of material position can be met only by a government with totalitarian powers … We must face the fact that the preservation of individual freedom is incompatible with a full satisfaction of our views of distributive justice."
  —F. A. Hayek

- "If you mix raisins and turds, they're still turds."
  —Charlie Munger

- "We can easily forgive a child who is afraid of the dark. The real tragedy of life is when men are afraid of the light."
  —Plato

- "Let us not dream that reason can ever be popular. Passions, emotions, may be made popular, but reason remains ever the property of the few."
  —Johann Wolfgang von Goethe

- "Warren Buffett has made a lot of money, some of it off of gaming the political system. He invests in insurance companies and then lobbies to raise the death tax, which drives people to buy insurance. You can get rich playing that game but it's all corrupt … It's not investing."
  —Grover Norquist, president of Americans for Tax Reform

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Publisher
Edelweiss Holdings Ltd.
31 Victoria Street, Hamilton, Bermuda
Editor
Tony Deden
Design and copy editor
Christine Weeks
Contact
mail@edelweissjournal.com