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EDELWEISS JOURNAL

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After a pause of three years, we are pleased to bring back the Edelweiss Journal to our shareholders and friends—many of whom have been incessant in their reminders to write again. Our 2015 reorganisation to an investment holding company has been successful not only in that it has allowed us to escape from the noise of the financial world, but also in that it has given us scope to rethink how we do things, how we govern ourselves, how we report and how we make the most of our resources. That was our principal endeavour during the past year. In the scheme of the world, we are a small company but with high standards—intellectual, operational and ethical. In consequence, the purpose of this publication is to share our thinking and noteworthy ideas on issues relevant to our purpose. As usual, it will be published irregularly. The simplicity of the new format echoes our affinity for clarity and modesty in thinking and in action. The editor welcomes your feedback and ideas. For correspondence, please send mail to ad@ehltd.bm.

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Reflections on Trump's America

> That which has been is that which will be, And that which has been done is that which will be done. So there is nothing new under the sun.[1]

Perhaps it was inevitable that a man like Mr Trump would some day end up in the White House. Immodesty notwithstanding, he is intelligent, patriotic, and richly endowed with that American *can do* disposition. His election, at least within the context of financial markets both in America and elsewhere, has been greeted thus far with the exuberance and fervour reserved for the second coming of an industrial revolution. Yet, even as one ought to welcome Mr Trump's businesslike ideas for a country that has veered further and further into an economic unknown, there is scant reason for the boundless euphoria of anticipated greatness—the subject of this brief essay.

To some folks, Mr Trump's words and promise to "make America great again" resonated with those of the late President Reagan. On one hand, it seems that he understands what's what. In a September interview with Reuters, he accused the Fed of having created a "false economy" (true) and "keeping the rates down so that everything else doesn't go down" (also true).[2] Responding to claims of alleged economic robustness, he said: "The only thing that is strong is the artificial stock market." On the other hand, the

[1] Ecclesiastes 1:9 (NASB)
[2] http://www.reuters.com/article/usa-election-trump-idUSL1N1BH0S3

grandiose economic policies and promises he has outlined demand a cheap dollar and even greater deficits and debt creation. His administration faces a federal debt of $20 trillion, unfunded liabilities of more than $100 trillion and 50% of a population dependent on (most, in fact, feel entitled to) some kind of government spending, which translates to the fact that much more credit/debt is a *necessity* and not an option. When Mr Reagan took office, circumstances were a lot different. Thus, the euphoria among financial and political pundits is unlikely to last long. The exuberance of the moment, no matter the soundness of expectations, may, for a while, give rise to higher share and dollar prices, but its consequences are trivial.

It's hard to know what Mr Trump means with the words "Make America Great Again." No one seems to have asked him. The first three words could well refer to some artificial conditions that merely generate confidence, enthusiasm—and retail sales. It is the *again* that holds the clues as to his understanding and motivation. If America *was* great, what was it that made it so? This isn't a subject for short essays.

Most Americans over the age of fifty would concur with the description of America today by Strauss and Howe:

> The America of today feels worse, in its fundamentals, than the one many of us remember from youth, a society presided over by those of supposedly lesser consciousness. Wherever we look ... we see paths to a foreboding future. We yearn for civic character but satisfy ourselves with symbolic gestures and celebrity circuses. We perceive no greatness in our leaders, a new meanness in ourselves. Small wonder that each new election brings a new jolt, its aftermath a new disappointment.[3]

The authors are not alone in this description. In Leonard Cohen's words, *everybody knows*. But while we agree that something has changed (for the worse), we are likely to find considerable discord among sociologists, historians, economists and theologians as to the nature of the greatness that America may have once possessed. Mr Trump does not tell us what the *great* in his slogan is. One suspects that his definition is similar to the one he would generously bestow on himself. But it can't be so. From Strauss & Howe again:

> Not long ago, America was more than the sum of its parts. Now it is less. Around World War II, we were proud as a people but modest as individuals ... Where we once thought of ourselves collectively strong, we now regard ourselves as individually entitled ... Popular trust in virtually every American institution—from business and governments to churches and newspapers—keeps falling to new lows. Public debts soar, the middle class shrinks, welfare dependencies deepen, and cultural arguments worsen by the year.

And on the subject of the much admired American sense of optimism:

> Optimism still attaches to self, but no longer to family or community. Most Americans express more hope for their own prospects than for their children's—or their nation's. Parents widely fear that the

[3] William Strauss and Neil Howe, *The Fourth Turning: An American Prophecy—What the Cycles of History Tell Us About America's Next Rendezvous with Destiny.* (New York: Broadway Books, 1997). This widely-read, thought-provoking, exhaustive and relevant book outlines the inevitability of a crisis through the prism of historical cycles. The boldness of its thesis has generated considerable applause but also criticism from academics who are focused on empirical robustness.

> American Dream, which was there (solidly) for their parents and still there (barely) for them, will not be there for their kids. Young householders are reaching their midthirties never having known a time when America seemed to be on the right track. Middle-aged people look at their thin savings accounts and slim-to-none pensions, scoff at an illusory Social Security trust fund, and try not to dwell on what a burden their old age could become.

Honesty compels us to agree, but it also demands we temper the exaggerated optimism for political remedies. "The basis for optimism is sheer terror," wrote Oscar Wilde. Indeed, judging only by the vigour of the animal spirits unleashed on Wall Street, we want to believe that the advent of a new American president will miraculously chart a road to some ill-defined greatness whilst avoiding the accumulated and compounded consequences of decades of folly.

Generally, financial problems, whether in a family, corporation or a country, are symptoms of a larger underlying problem. Greece is a perfect illustration.[4] Even in the European scene at large, an astute observer can easily discern that the financial problems of today are largely rooted in the idiotic ideas of a common currency, Pax Europa and the utter chaos they have spawned. The American situation is distinctly more complex insofar as it also embodies elements of a societal disintegration. From Strauss & Howe:

> We perceive our civic challenge as some vast, insoluble Rubik's Cube. Behind each problem lies another problem that must be solved first, and behind that lies yet another, and another, ad infinitum. To fix crime we have to fix the family, but before we do that we have to fix welfare, and that means fixing our budget, and that means fixing our civic spirit, but we can't do that without fixing moral standards, and that means fixing schools and churches, and that means fixing the inner cities, and that's impossible unless we fix crime. There is no fulcrum on which to rest a policy lever. People of all ages sense that something huge will have to sweep across America before the gloom can be lifted—but that's an awareness we supress. As a nation, we're in deep denial ... individually focused yet collectively adrift ...

At the heart of the matter lies the undefined "greatness" being promised by Mr Trump—an oblique reference to the political and moral marvel of the Founding Fathers—as perceived within the ruins of a republic which has disintegrated into a system of soft-despotism from which there is no peaceful escape in the short-term.

Thus, the election of Mr Trump, however better he may be perceived by some as against his opponent, is of no real significance. Putting aside personalities and the superficial political distinctions that divide them, over a longer perspective, Trump's America will be no different than Obama's America or Bush's America or what would have been Hillary Clinton's America in that it retains the illusion that the people are in control, when in fact they have no say over anything of any consequence.

Soft-despotism was coined by Alexis de Tocqueville, a 19th century French diplomat, historian and author of the remarkable *Democracy in America*, published in 1835 as a treatise on the social consequences of unchecked democracy and advice as to arresting its demise. Soft-despotism is a state in which people live obliviously in a mild sort of obscured tyranny

[4] See 'The "terrible trouble" of not just Greece', *Edelweiss Journal*, Issue 1, 12 July 2011, http://www.edelweissjournal.com/pdfs/EdelweissJournal-001.pdf.

despite the existence of external cursory forms of liberty and rights to property. Tocqueville's words from 180 years ago appropriately describe the status quo and the elusive pursuit of an uncertain greatness:

> *Our contemporaries are constantly excited by two conflicting passions: they want to be led, and they wish to remain free.* As they cannot destroy either the one or the other of these contrary propensities, they strive to satisfy them both at once. They devise a sole, tutelary, and all-powerful form of government, but elected by the people. They combine the principle of centralization and that of popular sovereignty; this gives them a respite: they console themselves for being in tutelage by the reflection that they have chosen their own guardians. Every man allows himself to be put in leading-strings, because he sees that it is not a person or a class of persons, but the people at large who hold the end of his chain … [Emphasis added]
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> *By this system the people shake off their state of dependence just long enough to select their master and then relapse into it again.* A great many persons at the present day are quite contented with this sort of compromise between administrative despotism and the sovereignty of the people; and they think they have done enough for the protection of individual freedom when they have surrendered it to the power of the nation at large. This does not satisfy me: the nature of him I am to obey signifies less to me than the fact of extorted obedience … [Emphasis added]
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> After having thus successively taken each member of the community in its powerful grasp and fashioned him at will, the supreme power then extends its arm over the whole community. It covers the surface of society with a network of small complicated rules, minute and uniform, through which the most original minds and the most energetic characters cannot penetrate, to rise above the crowd. The will of man is not shattered, but softened, bent, and guided; men are seldom forced by it to act, but they are constantly restrained from acting. Such a power does not destroy, but it prevents existence; it does not tyrannize, but it compresses, enervates, extinguishes, and stupefies a people, till each nation is reduced to nothing better than a flock of timid and industrious animals, of which the government is the shepherd.[5]

This is the present state of America and the whole of our western world, more or less. The Soviets were better at it. They managed something not wholly different, except with less overhead. Man does have a strong desire to be led. It's so much easier to have someone else direct his actions. He only pursues liberty after being ruined by a long courtship with serfdom. This is indeed why the American Founding Fathers did not refer to *leaders*—a modern political rank whose antecedents are rooted in tyrannical regimes.

Without doubt, these reflections may be altogether pointless to those unburdened by a principled and moral framework in political economy, or those for whom the pursuit of short-term gain holds priority. To others, ourselves included, anxious as to the long-term implications for the soundness of our savings, the patrimony we are to leave another generation

[5] Text quoted in this section is from Volume II, Section 4, Chapter 6, available at: http://xroads.virginia.edu/~hyper/detoc/toc_indx.html.

or merely the rights we barely hold as to our own property and its disposition, proper reflection is an indispensable component of critical action. (td)

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The Challenge of Preserving Capital within the Financial System

By James Watson[6]

After a decade of extreme monetary experimentation, it is now commonly accepted that global fiat money, expansionary money policies and central planning have served to distort the price-finding role of the free market and, as a consequence, the valuation of all assets.

We may all have experience from our personal lives of things that exist outwith the financial system which have come to be contaminated by QE. The connection is not always obvious but the transmission mechanism is firmly in place: It has never been easier for financial players and their favoured clients to get funding. Furthermore, there seems to be no shortage of innovation in financial transactions. Asset prices are distorted because risk has been distorted and the near-free credit has perverted the entrepreneurial calculation that determines the genuine viability of financial undertakings.

While business owners operating in the real economy will continue to relate more to the notion that a bank will lend to anyone who can prove they don't actually need the money, for those within the financial system, funding (credit) has never been easier. Nothing epitomises this more than the large private equity firms that have surely emerged as the major unintended beneficiaries of post-2008 monetary policy. Collectors of anecdotal evidence of market peaks may have thought they were on to something when Stephen Schwarzman paid Rod Stewart a reputed $1 million to perform at his 60th birthday party in 2007, but Mr Schwarzman may yet have grander plans for next year.

Chief among the fictions peddled by the financial establishment, is the notion that liquidity reduces risk. On the contrary, I would argue that, frequently, liquidity actually increases risk. 'Investing' in the certainty you can subsequently sell easily again introduces, however inadvertently, a risk, that is, a lesser standard of diligence to the acquisition itself. Put another way, liquidity emphasises the rights of the owner whilst reducing the burden of responsibility that should go along with ownership.

In the financial world, the presence of abundant liquidity has had the unintended consequence of encouraging behaviour by market participants (who are overwhelmingly agents and not principals) that may not necessarily be in the best interests of long-term owners of the underlying assets. Two examples of this unintended behaviour are over-diversification and high levels of turnover within investment portfolios. One of the problems of agency within the financial industry is the cluelessness that follows a conditioned experience in investing, the idea of looking backward for signs and patterns we remember, rather than, as James Grant suggests, "squinting into a fathomless future as we must," will never be questioned by customers.

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[6] James Watson is an Edinburgh-based investment company executive. This brief unpublished essay follows recent discussions and private correspondence with the editor.

He asks, "How can sane and sobersided fiduciaries toss their client's savings into the bonfire of sub-zero yields to maturity? There is an answer: A fiduciary must take the world as it is. Then, too, our world is familiar to us. Tumbling yields and manipulative central banks are what we know."[7]

The social imperative

The financial economy is too large, relative to the benefits it provides to society as a whole. I am not clever enough to say with certainty whether the trillions of dollars that are passed backwards and forwards between participants within the system provide any real benefit to those outwith the system, but I very much doubt it. The industry's licence to operate may well yet be questioned in a way hitherto unseen as democracy revives itself further.

The core of the argument in support of the scale of the system seems to be based on the notion that all the very clever things undertaken by the financial economy serve to *reduce risk* for the real economy. The provision of liquidity, diversification, hedging, and the rise of synthetic financial instruments are all examples of things that take place in finance land and which bemuse outsiders who are told simply that these clever things make their lives less risky. I find this unlikely and prefer to think it's mostly irrelevant to those who seek to manage and develop productive assets in the real economy.

Perhaps the nature of the modern day financial landscape is not significantly different to that of the industrial trusts that wielded enormous monopoly powers at the beginning of the last century. The pillars of the financial community certainly believe in their own power and influence, and theologians should not have been the only ones who took offence when Lloyd Blankfein claimed, however tongue in cheek, in 2009, that Goldman Sachs was undertaking "God's work".

We came close to an unwinding of the system in 2008, but the established order fought a desperate and ultimately successful rear-guard action in which the banking class convinced the political class that they were "too big to fail," and the politicians duly convinced the electorate of the same thing. It helped in both cases that the need to refinance bank balance sheets enabled the (poacher) banking class to turn (gamekeeper) advisers to the politicos as they began to sell mountains of government debt with which to refinance their unkeepable promises.

The world of finance needs, more than anything else, to reconnect with productive economic activity. What Mr Blankfein was referring to (above) was the important role banks play in financing the growth and development of real companies. That is true, but it is presently a small part of their overall activities and even then is limited to companies that have already achieved a certain scale, and who wish in the first place to consider selling their shares to the public. The real need for finance and allocation of scarce capital[8] extends well beyond the capital markets.

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[7] Grant's Interest Rate Observer, 15 July 2016.

[8] *Ed*.: The modern use of the word *capital* refers to all manner of money-like resources, whether newly-issued credit or the accumulated savings of prior endeavours. There is no scarcity as to credit whereas capital in the sense of accumulated savings is both scarce and irreplaceable.

Preserving capital

It should come as no surprise to those of us who believe that much of the financial system is rotten, that the options to preserve the real value of capital within that system continue to shrink. In days past, such options were thought to be a function of asset allocation with relative safety always to be found somewhere in the system. However, if it is the financial system itself that is engaged in a fight for survival, rather than merely the popularity of asset classes within it, liquidity within the system will be as vulnerable as is anything else.

The most obvious form of risk in liquidity is erosion through inflation, but there are other risks, mostly concerning the imposition of control over the financial affairs of individuals.

As an example, is the abolition of (only relatively) high value Indian Rupee banknotes a challenge to the money launderers, or rather is it at heart an attempt to force Indians into the banking system? If your aim is to seek to control the people, first you have to ensure they cannot escape your control structure. In the case of India, this repudiation will certainly add to the distrust that its own people already have for the nation's currency. Those of us in the West have yet to learn to distrust the money monopoly.

It is startling to me that young people, who prize so much the flexibility of the "sharing economy" and the freedom of communication given them by advances in technology, are so willing to subjugate themselves to loss of freedom when it comes to financial affairs. Bank credit and electronic facilitation payments are very much the order of the day whilst the use of cash as a form of payment is almost seen as "grubby". However, at what price individual freedom?

Is it just possible that the much heralded new Bank of England £5 note—ironically, praised for its durability—is part of a broader scheme to reduce the number of notes in circulation thereby forcing cash back into the financial system? There are many hidden ways of seeking to gain increased control before outright capital controls and restrictions on cash withdrawals.

If the ultimate risk we face is to the financial system itself, then it seems logical that to mitigate that risk we must seek to escape the system. Of course most financial investors are not able to do this, as a result either of a lack of scope in their role as agent or for want of personal skill. And so, the political class will ultimately triumph in resetting the system around them. Some will do relatively better than others, but it is likely only to be relative and it will ultimately become obvious that it is impossible to protect the real value of capital within the financial system itself.

The bifurcation between financial and real economies has grown ever larger, and this has been to the benefit of participants in the financial economy. Precisely because of the scale of this gap between the two, and because of their very different modern natures, a transition back to the real world provides an insurmountable challenge for most who have spent their careers developing skills suited now only to the financial system. That these beneficiaries may come to be trapped in the system by the very skills they have developed to profit from, may provide a pleasing irony for those who've been toiling diligently elsewhere. Sadly, the casualties will not be limited to those would be masters of the universe.

In this scenario, owners of real productive assets, which are genuinely scarce in nature and unavailable to most, seem best placed to prosper. For they do not require liquidity within the financial system, nor to be told what the current price of their company's shares is. Furthermore it is likely that, in times of real adversity, the best of these businesses will find opportunities to strengthen their position further.

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"Be more cheerful" was the editorial advice we recently received from a shareholder on learning that we are to restart the *Edelweiss Journal*. Well, that's the plan. Starting with the next issue, of course. In the meantime, we take the opportunity to send you and your family every good wish for Christmas and the coming New Year.