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Asset Allocation For Our New Reality

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By J. Michael Martin

For an entire generation, advisors and investors were swept up in an intoxicating environment of unbridled opportunity: the dismantling of the Soviet Empire, the resurgence of capitalism in Asia and Eastern Europe, the Internet revolution, a global credit boom, the trade boom, the housing boom and the energy boom. That was our investment context, and while it lasted every market correction was an investment opportunity. As everyone now knows, the cheap and plentiful credit that supported this giddy expansion has imploded. And that changes everything, though not everyone realizes it.

Many of us were first jostled from our American reverie when it was brought to our attention this year that equities have lost money for an entire decade! Whatever happened to that fabled 10.4% average annual return over the long term we brought out to encourage nervous clients? As advisors probe for answers, many have begun to examine their basic big-picture assumptions about the world in which we live and earn our living. When they do, their discoveries are sometimes unsettling.

One example: Our team at Financial Advantage is convinced that the current GDP contraction is not at all like the brief inventory recessions typical of the past 75 years, and so it is not helpful to examine it through the lens of those experiences. This downturn is far more ominous, of an entirely different species, the illegitimate offspring of a seductive credit cycle and a naive generation of consumers and investors. If past inventory recessions were an unwelcome fox in the henhouse of our prosperity, this long-overdue credit collapse is a starving 10-foot Kodiak mauling our portfolios. This is not a market correction, but the dismantling of the investment environment we knew and loved, to be replaced by … well, we really don't know what yet, and that's what is so unsettling.

In A Nutshell

Here's a thumbnail of the current situation that every investor must have in mind for decision making: For over a quarter century, Americans and their government binged on consumption and eschewed savings, and the rest of the industrialized world followed our bad example.

Consumer indiscretion provided a heady operating environment for most businesses, replete with record-high profit margins unlikely to be seen again for a long time. The long consumer boom culminated in beautiful bubbles for house prices, stock prices and commodity prices. The bursting of those bubbles is already in the history books along with tulip bulbs and other manias. But the consequences of the credit boom and bust linger on.

What consequences? For one thing, an intensely competitive business environment that will last until we have shrunk our productive base to match our downsized needs. And, oh yes, debt. What will become of all those obligations we took on when the sky was the limit?

There is a Wall Street adage that says every debt will eventually be discharged, either by the borrower or the lender, (i.e., through a repayment or a write-off). Lenders and borrowers (and their respective representatives in the nation's Capitol) are now locked in an epic struggle to determine just how our $52 trillion mountain of interest-bearing obligations is going to be discharged—or at least reduced enough so that our aggregate economy can grow again. How this struggle is decided will largely determine investment risks and opportunities over the next five to ten years.

I Can't Like It!

My grandson, William, is almost 3 years old. He is generally a cooperative toddler, but if you try to get him to eat something he doesn't want, he will look right at you, shake his head and say plaintively, "I can't like it!" Like William, the stock market doesn't seem to like what it's being offered every time the government announces hundreds of billions of dollars of new bailout or stimulus money.

This magazine's readership is probably as divided as the country at large about the appropriate role of government in solving our "banking crisis" and "stimulating the economy." Some of us are troubled by the prospect of government-dominated banking, insurance, health care and auto industries. Others are so disappointed at the self-serving behavior by some captains of industry that we're inclined to shift our hopes from Wall Street to Washington.

It may be that the 50% drop in stock prices is fully explained by the terrible GDP data, the rising defaults, the earnings disappointments and the discouraging employment figures. Or it may be that owners of private capital are worried about something bigger, something that threatens the economic world as they know it.

Most of our mothers taught us not to talk about politics in public. It's hard to deny the wisdom of their instruction. After all, you can get people upset; better to be friends. But if we take seriously our responsibility to shepherd our clients' resources and help them achieve their goals, perhaps we have a duty to look a little closer at the big-picture implications of expensive government proposals. Is there a possibility that what began as "a search for the solution to the credit crisis" could morph into a contest of ideas: socialism and collectivism versus individual responsibility and free markets? If that happens, can we do our jobs without examining these ideas?

If the several trillions of dollars of government programs are pulling us toward a government-dominated economy, it will change our world. It will radically alter the investment landscape. It suggests redistribution and class warfare; it implies bureaucratic red tape rather than market-responsive private industry. It implies an attempt to solve a debt problem by adding more debt, namely government debt that is backed by, well, nothing. These are scary concepts unlikely to inspire the sort of risk-taking that spawns innovation and productivity. Though some of us think these are non-issues, the markets' behavior suggests that many stockholders are worried about them.

When examining the government solutions being offered up, I feel a little bit like William. I can't like it.

Yes Or No?

We don't think an advisor can cobble together a sound investment strategy without first answering this yes-or-no question: Will the aggressive package of government spending and guarantees jump-start our economy and restore its growth to what we've become used to?

In our opinion, there is no hiding from this question, especially not for well-off retirees hoping to preserve the buying power of their nest eggs, and certainly not for the pre-retiree or midlife saver struggling to build a financially secure future.

Our appraisal is that these enormous government programs will eventually prove to have been a mistake, an interference with the market process on such a grand scale that it will only succeed in increasing our national debt, raising our tax burden and raising interest rates. Also it will raise the risk premium for equity capital (in other words, it will lower the prevailing P/E). Furthermore, it will reduce risk-taking and innovation, generally impairing this free-market economy that has been for so long the envy of the world.

At our firm, we're building portfolios with the expectation that the restoration of economic growth is probably still years away. We also assume that stock prices still reflect an unrealistic expectation for early recovery and assume that interest rates on government debt are artificially low and will eventually be driven higher by inflation expectations. We are in a transitional investment period that requires a kind of diversification quite unlike the formulae that worked during the long credit expansion.

We believe for a number of reasons that the smorgasbord of expensive government programs is unlikely to re-energize our economy, and thus that the burden of proof rests on the optimists.

Though no two periods are identical, the history of similar government efforts in similar circumstances does not augur well for rapidly expanding government intervention. Consider the succinct appraisal of Franklin Roosevelt's Treasury secretary in 1939: "We are spending more money than we have ever spent before and it does not work. ... After eight years of this administration, we have just as

much unemployment as when we started (20%) and an enormous debt to boot!" Then there was Japan's dismal failure to orchestrate a recovery during its "lost decade" of the '90s by artificially depressing interest rates, propping up banks and spending a trillion dollars on stimulus.

The average citizen is hunkering down, cutting his spending and increasing his savings. While this is the right and healthy response, in the short run it means contraction and deflation.

The credit contraction has been deflationary, especially in the notorious housing sector, and provides a financial incentive to put off buying that first home. Much of the money government is throwing at the foreclosure problem will only underwrite the refinancing of existing mortgages, doing little to remove the inventory glut.

Any realistic assessment of the potential number of jobs "created" by the spending programs seems far short of the job losses actually being announced in the private sector. Furthermore, many programs will not actually get under way for three or more years.

Besides these problems, there are more shoes that are going to drop. We still don't know the depths of the bad debt problem for banks. There's even more bad news in the wings for pension plans, state budgets, insurance companies and those who were counterparty to the untold trillions of dollars in derivatives, not to mention a protectionist spiral of currency devaluations.

The government hopes spending will revive the over-indebted economy, but there are compelling reasons to think it could fail. We must ask: How is more debt going to fix the problem of too much debt? Good question, we think!

Investing For The Transition

It is not our job to make government policy. Our job is just to make sound investment decisions for our clients in the policy environment we are given. As someone recently said, the Keynesians have won, so we have a good idea what the policies will be. What should our portfolios look like as we wait to see how things turn out? Here are a few of the things that can help us earn positive returns during an uncertain interim.

We have a lean equity exposure. Overall, stocks seem priced for an economic recovery within six months, which we think is very unlikely in light of the credit system repair that needs to happen. Our long equity exposure net of shorts is near zero.

Investment-grade debt is a category where current yields promise equity-like returns but also puts us higher in the capital structure at a safer place than stocks.

We use short positions. While the stock market is overpriced, it makes sense to make investments that will benefit from falling prices. We use inverse index funds and actively managed "bear" funds that short individual stocks based on fundamentals.

We use paired trades. For example, we are short in the 30-year Treasury while at the same time long in an investment-grade bond fund, a strategy that will allow us to profit from what we believe is the inevitable closing of the unusually wide spread in interest rates on these two bond categories.

We use currency hedges. In the present debt crisis, the government could abuse its power by devaluing the currencies in which debts are denominated. Gold bullion is one obvious place of refuge for those seeking a non-corruptible store of value.

We will frequently rebalance. It seems reasonable to expect continued price volatility. In an unstable environment, frequent rebalancing is a low-risk strategy for adding value to a portfolio over time. We call it, "making volatility your friend."

Like water seeking its level, capital seeks an acceptable risk-adjusted return. Now that the dangers of leverage have been unmasked, frightened capital has been pouring out of stocks and into Treasurys at a near-zero yield. As capitalists, we think that return is unacceptable. A portfolio properly diversified for our new realities should do better.