Capital Drain

Rick's investment opinion newsletter June, 2012 v.8 no.3

Before printing, think about the environment

Hi Readers,

The world, including the investment part, has been particularly turbulent lately. For all of that, the investments I've mentioned (starting nearly two years ago!) are still doing pretty well.

I can't see any reason to expect that the situation will get sharply better or worse any time soon.

So, I'm sticking with the same story. In my opinion:

Executive Summary:

- The madness of crowds, and the Flash-Mob era
- The economy is slow but growing
- Despite the noise things are not so bad except for Europe
  - Europe will muddle through, too.
- Banks as intermediaries during disinflation
- Behavioral Finance: “Why Smart People Are Stupid”

The recovery continues, and many US companies are doing well, but the prices reflect high continued growth expectations. If you're holding shares of any of the conspicuous high-fliers, especially the “hot” new tech IPOs, you might consider selling into this enthusiasm. Better to risk a little less gain rather than a lot more loss.

As confidence in the economy spreads, investing in all-market index funds becomes more attractive. We are likely reaching the phase where a rising tide will lift (almost) all boats.

If you're inclined to pick among individual stocks, be conservative and be in the best of securities: stick to value, to safety, to short maturities (for debt), and call me to chat if you’re concerned about anything you’re holding.

Above all, avoid the investments that are at all-time extreme valuations: junk bonds, developing-country bonds, and headline-grabbing stocks with high P/E ratios.

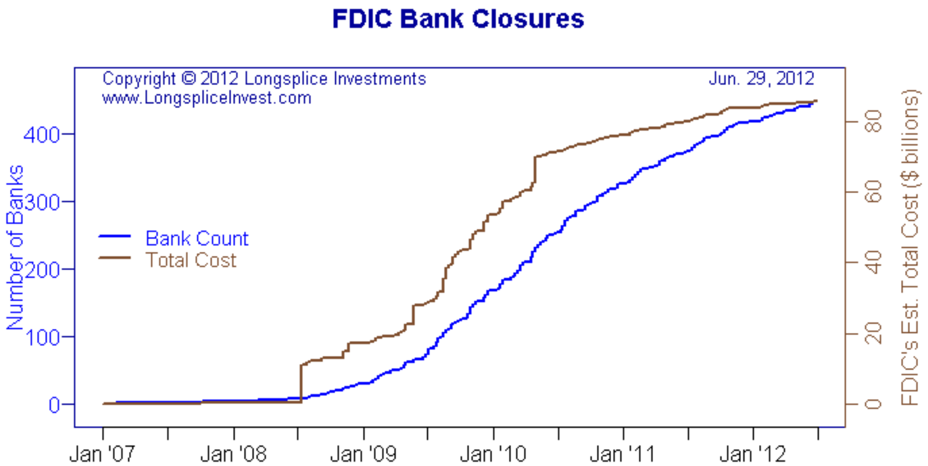
The Details:

One hundred and seventy-one years ago, Scottish journalist Charles Mackay published his Extraordinary Popular Delusions and The Madness of Crowds.[1] Some people still have not learned his simple and fundamental lesson. If anything, modern communications have made the crowds bigger and madder. Dear readers, please tell me that you did not participate in the farcical IPO of Facebook. Thank you.

We've had more than the usual number of financial bubbles this past decade and a half, and more than the usual number of corresponding financial bubble bursts. I'm not sure that we've reached the end of the episode, but I can offer simple advice to avoid being one of the victims:

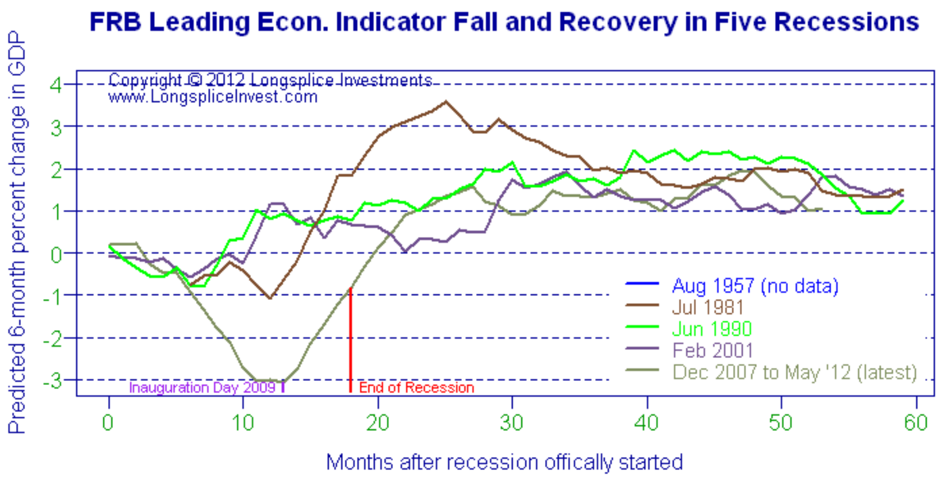
There are still no free lunches. Neither has the world ended yet, not even once. If it seems too good-- or bad-- to be true it probably still is. If everyone you know is jumping on a bandwagon, be skeptical. That applies to the End-of-the-World bandwagons as well. Maintain your balanced perspective, and wait for the recession and wobbly investment environment to get better.

The US economy is hanging in there, still expanding but not as fast as even a normal recovery.

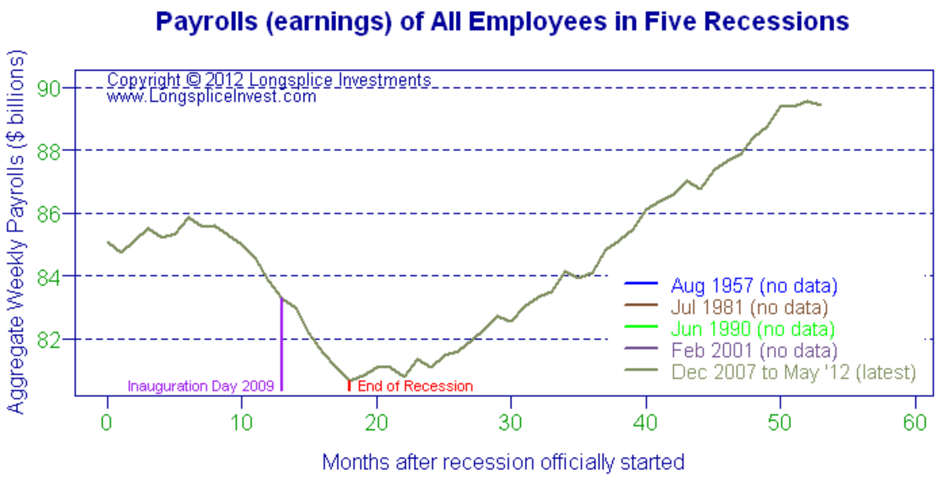


First of all, the bank failures that started the whole crash have slowed to a trickle, and the banks that the FDIC has to rescue are mostly small. Fewer failed banks means fewer disruptions in local loans to small businesses and new home buyers. That's good.

1 http://en.wikipedia.org/wiki/Extraordinary_Popular_Delusions_and_the_Madness_of_Crowds



The leading economic indicators from the Conference Board and the Federal Reserve continue to show slow but steady growth expected over the next six months. It's very slow, though, good but very disappointing.



The growth is slowing because total employee earnings in the economy has gone flat. The private sector is still creating jobs, slowly, but the public (government) sector is still laying off police and teachers and paramedics because of continued budget problems.

It's a vicious cycle that the lukewarm economy is still not producing a lot of tax income, so governments have to cut if they are to balance their budgets, so fewer people are working, so less tax is paid, and so on.

The recovery could be going much faster. The economics profession has known since shortly after the Great Depression how government spending can shorten the recovery time and get the country back to work (and paying taxes.)

Sadly, our problem is political: the “Government is the problem” faction in Congress is proving their point by being the problem. They're blocking the infrastructure and civic spending that could be revving up workers' income and spending faster. At the same time, they're defending the tax breaks for the very wealthy as “good for job creation.”

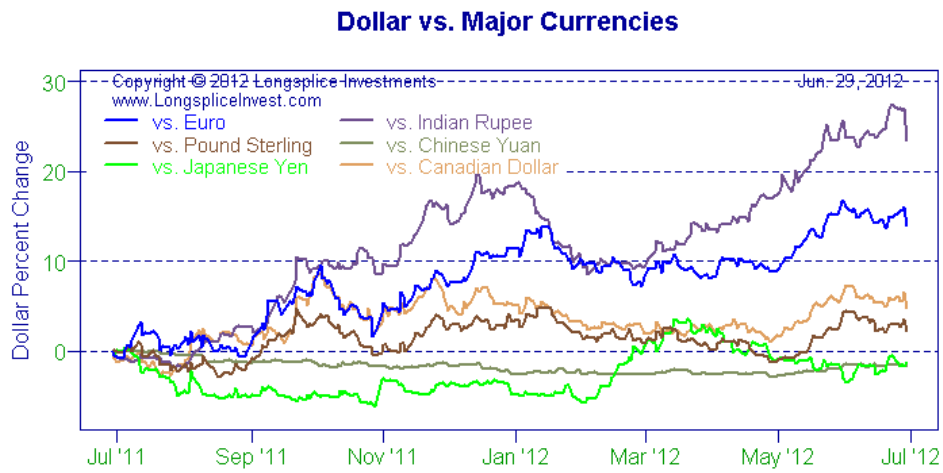
Actual business people are quite blunt in surveys: the problem in the economy is not lack of investment capital, it's lack of consumer demand. Business managers are not hiring more people because there aren't enough customers to justify the hiring. The very wealthy are neither creating jobs with their after-tax windfall, nor are they even consuming significantly more. Their extra income is being saved at a time when banks are sitting on deposits, doing our recovery no good at all.

As frustrating as that is for American workers and business owners, we've actually got it better than folks in much of the rest of the world.

In particular, the debt crisis in Europe is spilling over to reduced purchasing by Europeans of goods from everyone else, including the US, China, and India. Our reduced exports to Europe are another drag on our recovery.

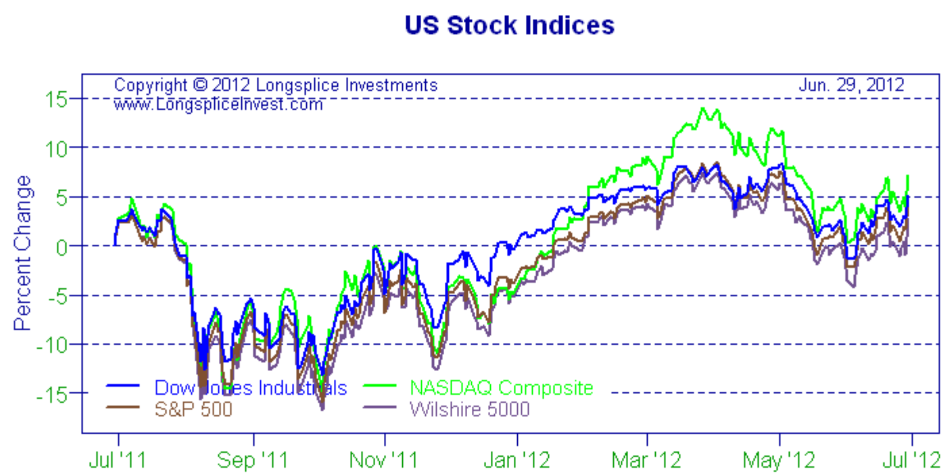
The situation in Europe is definitely a mess. I assume you've heard more than enough already to appreciate that. The only thing I want to add is: remember that for every bad loan, there was both a borrower and a lender. The banks that lent Greece and others so much money were complicit enablers. They could have refused to make the loans long ago, but they bet that there would be a European Union government bailout. For the most part, they won that bet. The citizens of Europe are being bled daily now to assure that banks won't lose money on loans they should not have made.

The smart way to pay off debts is to invest for growth. More jobs, more income, more tax, more debt repaid. Forcing a decade of poverty on the debtor countries is not going to help anyone economically.

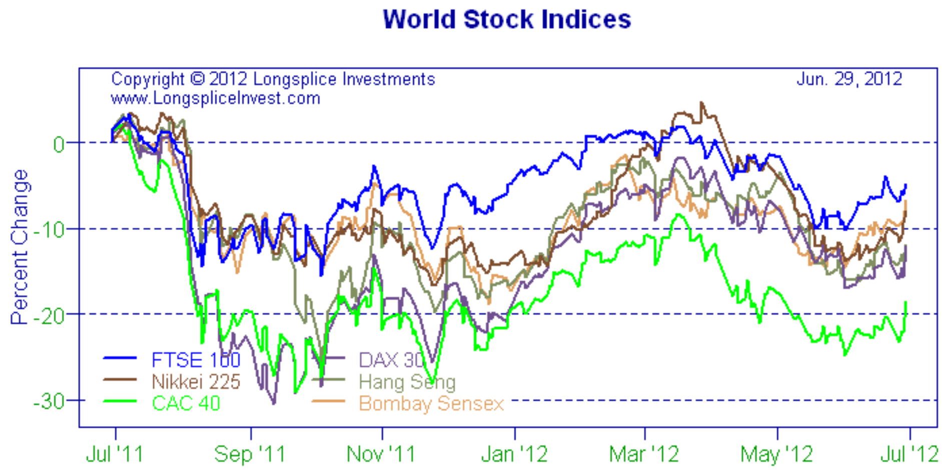


Clouds do have silver linings, though, one of which shines on the US. The fear and uncertainty in the rest of the world, especially in the Euro zone, is making the dollar strong. That in itself is a mixed blessing; it lets us buy imports more cheaply, but it further hinders our ability to export our goods to the rest of the world.

The time to really reap the blessing will be when the world economy starts growing steadily again. Investing strong dollars in a diversified world-wide portfolio will give an extra boost to your expected returns.



I am still happily invested in the Blue Chip dividend-paying stocks I listed nearly two years ago ([October 2010 newsletter](), bottom of page 5). The dividends have been as good as expected, some dividends have been increased, and the modest gain in the overall stock market has lifted these stodgy old profit-makers right along with all the flashy new high-tech profit-promisers. Also, my original list of 11 stocks has become 12! Conoco Phillips (COP) spun off Phillips 66 (PSX). Each has a good dividend yield and the earnings to pay for it.



Stock markets in the rest of the world aren't doing so well. The US has its problems, but those problems are smaller than many other countries. Wait and watch, and prepare yourself mentally for a switch to riskier, more global investments sometime in the future.

The Euro zone has economic problems, but the roadblocks to a solution are political. Happily, their politicians still know how to talk and learn and compromise, so they will work their way to a solution. There is nothing fundamentally flawed about Europe that should prevent a recovery.

The economic theory of banking is that banks act as intermediaries. They gather the excess cash of many small savers, and lend it in bigger chunks to businesses, home buyers, and so on. The banks make money by paying the savers a modest but attractive interest rate, and charging the lenders a higher rate based roughly on the riskiness of the loan.

During this financial crisis and the ongoing recession, that has not worked as well. The banks are not eager to lend to anyone, so they are sticking to the least-risky borrowers, and even so charging a relative hefty interest rate. Since there's reduced bank lending, and since the Federal Reserve has been trying to assure that every bank could borrow whatever it needs cheaply, the banks are not inclined to pay small savers much interest at all.

This is terrible news for retirees and others who depend on the interest earnings from their savings. The meager interest rates mean either living on very little current income (there are limits to how low you can go) or having to spend some of the savings nest egg itself, further reducing future income.

The banks are still acting as intermediaries, but now they are passing the weakness of borrowers and the cheapness of money from the Fed to the hapless small savers.

One of Life's Persistent Questions is “Why do smart people do such dumb things?” Behavioral Finance offers an answer: overconfidence. Smart people are smart, no doubt about that. In their normal lives, especially in their professional or recreational specialties, they are accustomed to being right; they trust their instincts and their snap judgments. In their normal lives, that works. They are confident, with good reason.

When people stretch to other areas, to questions that aren't necessarily complex but also are not familiar, then their faith in their snap judgments can cause problems. Confidence becomes a fog that obscures attention to detail. The New Yorker has published a nice short and lively article on the subject, "Why Smart People Do Stupid Things"[2]. It's not just a theory, there are examples you can try yourself. I hope you'll enjoy reading it.

If you have any questions, please write or phone. If you want to read more, the company web site has archived editions of this letter, lots of charts, and links to other interesting sites. There's also a web log where I discuss the process and progress of starting the mutual fund, along with occasional economic or investing thoughts..

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Take care,

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"Our doubts are traitors,
And make us lose the good that we oft might win,
By fearing to attempt."
--W. Shakespeare

2 Jonah Lehrer, "Why Smart People Are Stupid," The New Yorker, 12 Jun 2012, Condé Nast, 20 Jun 2012 <http://www.newyorker.com/online/blogs/frontal-cortex/2012/06/daniel-kahneman-bias-studies.html>.