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Eve of Destruction?

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And you tell me over and over and over again my friend
Ah, you don't believe we're on the eve of destruction.
-- Protest song written by P. F. Sloan in 1965,
recorded by Barry McGuire.
http://www.youtube.com/watch?v=IwYNWYaS3bI
Watch it performed if you really want to hear it again

The four most dangerous words in investing are "This time it's different."
-- Sir John Templeton

From the Wikipedia entry on Benjamin Graham's 1949 seminal work on value investing, *The Intelligent Investor*:

> Graham's favorite allegory is that of Mr. Market, an obliging fellow who turns up every day at the share holder's door offering to buy or sell his shares at a different price. Often, the price quoted by Mr. Market seems plausible, but sometimes it is ridiculous. The investor is free to either agree with his quoted price and trade with him, or ignore him completely. Mr. Market doesn't mind this, and will be back the following day to quote another price.
>
> The point of this anecdote is that the investor should not regard the whims of Mr. Market as a determining factor in the value of the shares the investor owns. He should profit from market folly rather than participate in it. The investor is advised to concentrate on the real life performance of his companies and receiving dividends, rather than be too concerned with Mr. Market's often irrational behavior.[1]

So what is this all about - back to the 40s or the 60s? Are we having a bout of nostalgia? No. To put it quite simply, we can learn from history or repeat past mistakes, our choice. Which do you choose?

The strident voice in this famous song represents a high level of conviction in a point of view, so high, in fact, that he keeps shoving the fact that the listener disagrees back at him as if even a dolt like him must see his own folly. Those of us old enough to remember the 60s remember this attitude, people with a monopoly on the truth and not shy in letting us know about it in loud voices.

[1] The Intelligent Investor. (2011, June 29). In *Wikipedia, The Free Encyclopedia*. Retrieved October 27, 2011 from http://en.wikipedia.org/wiki/The_Intelligent_Investor

Well, turns out we were not on the "eve of destruction." It was not different that time. As compelling a case as they tried to make for the end of everything, they were wrong. The world did not end, unfortunately, because what followed was even worse – the 70s! Can you say "polyester?"

Fast forward to now

Moving right along, how about now? Is it different this time? Are we on the "eve of destruction"? Or, perhaps worse, are we facing PIMCO's "New Normal" of deleveraging, low returns, high risk, and the heavy hand of government taxation and regulation suppressing business growth? Let me respond to that with two facts:

1. The New Normal stuff rolled out in 2009 or so, just in time for the biggest equity rally in a very long time. They were calling for a long, slow recovery, if any.
2. This year PIMCO, based on these views, sold out of treasuries in their Total Return fund, used by many of our clients. That move cost the fund some return, as treasuries performed very well. More on that below.

Based on the record, I would suggest that we ought to be fairly skeptical of market forecasts, especially ones that explain why this time is different. We can all see the problems, this is not an easy situation, and much of the analysis done by PIMCO and others may be correct, but what we can see is that having a solid and plausible analysis does not seem to enable you to predict where the market is going to go, or what future returns are going to be. I keep hearing they will be very low – are we really so sure of that?

Wisdom from the past

The two small pieces of wisdom above have a lot to teach us, as we contemplate our famously New Normal world.

First of all, why in the world are we ever willing to accept "it's different this time"? It never was before, not on the upside when all appeared rosy, nor on the downside when the end of life as we know it loomed, nor when a New Normal called for "new strategies". We seem to get the same result every time – the market defies the forecasters and surprises us.

Secondly, long-term investing turns out to be about healthy businesses earning profits and ultimately paying dividends for investors. Thus the piece from Graham's famous work, where his Mr. Market character makes up new prices every day, but that does not distract the intelligent investor, who looks at the businesses he owns, not the fluctuations in the market. If you own healthy businesses (purchased at a reasonable price) for a long time, you make a good return; that is fundamental.

Speaking of communications and media

Did you know?

- Johannes Gutenberg invented the printing press, perhaps the most important invention in the history of communication and knowledge, around 1439.
- The typewriter was invented in 1866 and was ubiquitous until the personal computer came along more than 100 years later.
- Speaking of Steve Jobs, the Apple II was introduced in June 1977, when I graduated from college. Within a decade typewriters were virtually gone.[2]

What's the point? In my post-college lifetime we have gone from a world of typewriters and carbon paper to the internet and all that goes with it. The enormity of the change is probably not fully apparent yet, but we are encountering some powerful undercurrents, and wanted to share one here.

A big one is the use of social media networks for communications. When I worked for a small advisory firm in the mid-90s we did not have a website, were not sure anyone would use the internet for business (LOL). Of course, when I left Wells Fargo Investment Advisors (now Blackrock) in the early 90s, they didn't even have email or server networks; they did have old Prime computers! Seems like a long time ago.

We are now not only promoting the use of our website, but also our blog, Facebook, Twitter and LinkedIn pages. We frequently post links to interesting topics, usually economic or investment-related, but not always. There are several important advantages to this approach:

1. It's a lot faster than setting up metal moveable type on a Gutenberg press!
2. We don't need a typing pool, and we don't get carbon smudges on our fingers.
3. No more paper cuts and nasty tasting glue on stamps.
4. We can communicate far more, but you can be highly selective in what you read.
5. You can respond instantly, and even engage in an online discussion if you like.

One recent example is the link to *The Economist* lead article this week, "Rage Against the Machine."[3] We think it expresses a sensible point of view in reasonable terms, useful and informative whether you agree with them or dispute them. We provided a link on our LI and FB pages– have you connected with us yet so you could see it? We hope you will, and we would love to get your feedback.

[2] Except to this day some government agencies still employ the typewriter, believe it or not, but that's a story for another day.

[3] 22 Oct 2011. Rage Against the Machine. *The Economist.* Retrieved from http://www.economist.com/node/21533400

Investment corner

PIMCO made the call this year that treasuries were being supported by massive buying of them by the Fed, called “quantitative easing” (QE I and QE II). Bill Gross publicly predicted that after June 30, when QE II would end, treasury rates would go sharply higher. In effect, the credit quality was lower and people would demand higher rates of interest to keep buying them.

This view caused them to sell virtually all of the treasuries in the Total Return bond fund. As it worked out, they were dead wrong. All the worry caused a traditional flight to quality --people were buying treasuries, not selling them. Prices went up as rates fell. The Total Return fund underperformed by several percentages points, a large margin. This was a significant issue in client portfolios holding the fund this past quarter.

As a side note, PIMCO was not alone among bond managers in underperforming. Only 8% of the funds in Callan’s core bond database were able to beat the Barclays Capital Aggregate Bond index in the third quarter. Active bond managers tend to underweight treasuries in favor of corporate or other “spread product” that offer higher yields, and the rally in treasuries took many by surprise.

We will be discussing this issue with all of you in our quarterly meetings soon enough. Let us say here for the record that we do not think this one mistake makes PIMCO a bad bond manager, and we are not pulling the plug, but we are certainly watching closely. Long-term performance is still good, but we are hoping to see some recovery over the next few years, and not recovery coming from incremental risk. Stay tuned.

Sincerely,

Roger C Hewins III

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President

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