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Investment Managers

Value Thoughts to Ponder in the Midst of The Great Experiment

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The ongoing actions of global governments to sustain their financial markets are aptly being called "The Great Experiment". The current situation is unprecedented in financial history, thus we do not have the past as a guide for the future. So when a living legend like Warren Buffett dares to put forward a perspective on the world's predicament, we would have thought it would garner much attention and discussion. Yet Mr. Buffett's recent words of wisdom are being largely ignored. It seems to us that the Curious Case of the Dog Who Didn't Bark has been turned upside down and we want to explore why Mr. Buffett's thought on this Great Experiment have been brushed aside.

In the middle of August, Mr. Buffett published an op-ed piece in the NY Times entitled "The Greenback Effect" in which he explained the size of the new debt burden faced by the US Government, and made some simple (albeit generous) assumptions on how this debt would be financed. He concluded that the most likely and most politically expedient solution would be inflation and the debasement of the US dollar.

For your convenience, we have outlined his article in the following table, and we have briefly summarized his discussion. Mr. Buffett highlighted that the US government has taken on a new US $1.8 trillion deficit, which will need to be financed somehow. If it is assumed that a) foreigners take all cash received for exports sold to the US and invest in US government securities, and b) US citizens save more and every penny saved is used to buy US government securities, this still only accounts for half the debt burden (roughly US $900 billion). To finance the other half of the debt burden, the US government will have to effectively "print money", and there are three methods for doing so. One, the government can raise taxes. Two, the government can cut back on expenditure programs. Three, the government can allow inflation to rise. The first two methods will be difficult to implement and politically disastrous. The easiest solution for a politician (recall that Mr. Buffett was a congressman's son) is to allow currency debasement and inflation to drift up- this can be done without the need for a vote! Mr. Buffett warns that although the impact from the stimulus may be invisible now, its threat may be "as ominous as that posed by the financial crisis itself".

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Buffett's Economic Equilibrium

Fiscal stimulus has increased federal debt this year by	($1,800 B)
This increase in federal debt can be financed by:	
1. Borrowing from Foreigners	+$ 400
• Current account deficit	
• Assume 100% used to buy U.S. Debt	
2. Borrow from Americans	+$ 500
• Assume Americans will save **more**	
• Assume 100% of savings used to buy Treasuries	
3. Print Money	$ 900
• Raise taxes? } Politically Unpalatable	
• Cut government spending programs? } Politically Unpalatable	
• Let inflation drift up (debase the currency)	
	0

"Legislators…can opt for inflation, which never requires a recorded vote and cannot be attributed to a specific action that an officer takes." – Warren E. Buffett

"…threat may be as ominous as that posed by the financial crisis itself."
– Warren E. Buffett

Source: "The Greenback Effect", The New York Times, August 18, 2009

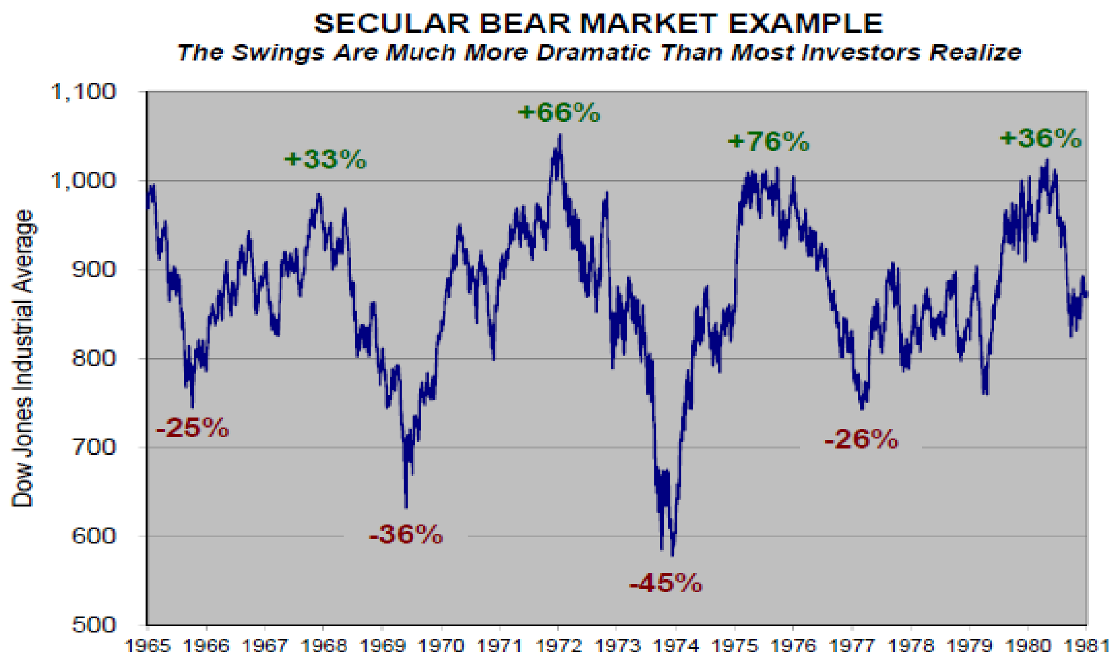
We found Mr. Buffett's views to be a powerful antidote to the significant stock market rally that has occurred since March. So we were surprised that his article barely created a stir and was soon lost in the barrage of market information and views that flood the system regularly. We had expected a flurry of essays ruminating on Mr. Buffett's logic and analyzing his conclusions, but found we could barely find any. When we asked peers about their reaction to the essay, we found that many had not even seen the piece.

Sionna has long believed that financial markets are not rational in the short term due to human nature. Humans have a tendency to be irrational and to overreact. We often seem to need to find ourselves in an emergency room before we are convinced to mend our ways and take corrective courses of treatment. Academic studies have shown that markets are much more volatile than underlying fundamentals would ever suggest. Despite our advanced knowledge of the Capital Asset Pricing Model, we all convinced ourselves, using elaborate econometric models and sophisticated cash flow analysis that we would no longer be subject to the irrationality of the past. Sionna believes that the flood of information that investors are constantly exposed to is contributing to the market's current irrationality. It is the complex and difficult to understand information that often causes us to turn away from relevant and important news, and instead turn to easy and fun to understand "infotainment". We looked up Mr. Buffett's essay on Google and found 24,200 "results". At first glace, this may seem like a significant response, until compared to the recent top news story "Balloon Boy" which has garnered over 16 million "results". It is easier to capture the public's attention with a relatively meaningless event, while

serious market advice from a leading expert on the world's most significant economy goes largely unnoticed, despite the profound historical and cultural implications discussed.

Alas, the market trend is bullish at the moment and thus the market doesn't want to hear a tale of caution…even from an esteemed market observer. However, a market not immediately reflecting or recognizing a change does not mean that it never will, nor does it mean that the current blind spot is the correct perspective.

At Sionna, we continue to believe that North American (and several global stock markets) are likely in the midst of sideways or range bound markets, where sustainable capital gains are elusive and fundamentals are slow to catch up to prices. The Dow Jones Industrial Average has crossed the 10,000 mark in an upward trajectory 27 times in the past 11 years, in other words, a lot of heading nowhere. The market was very expensive at 10,000 in 1999, somewhat expensive today at that same level and we expect it will be a downright bargain at 10,000 in 5 years or so. At that point, the speculative excess will have died down, and the market timers will be completely exhausted and no longer significant drivers of market action. The chart below demonstrates the extreme volatility of the last major US sideways market.



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As The Great Experiment unfolds, we continue to believe that a defensive positioning is a prudent course of action for Canadian equity investors in order to preserve and defend client wealth.