Capital Drain

Rick's investment opinion newsletter May, 2014 v.10 no.3

Before printing, think about the environment

Hi Readers,

I don't have much to say this month, so (because I'm not a politician) I am not going to say much. This will be quick.

In my opinion:

Executive Summary:

- 1Q GDP revised to a small drop: no worries. Other news is better.
- 500th dead bank: the FDIC is still cleaning up the bank mess, but nearly done.
- Pfizer update: they dropped the AstraZeneca bid, but still have a problem.
- Investing addendum: “What's cheap?”
- Tim Geithner's book: unrepentant and defensive.

The recovery continues, many US companies are doing well, and the prices reflect continued growth expectations. I remain leery of the conspicuous high-fliers, especially the “hot” new tech IPOs. Maybe I'm just too stodgy to go for what I think is glamor with insufficient substance. If so, lately the rest of the market has started getting stodgy, too, both here and in China.

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

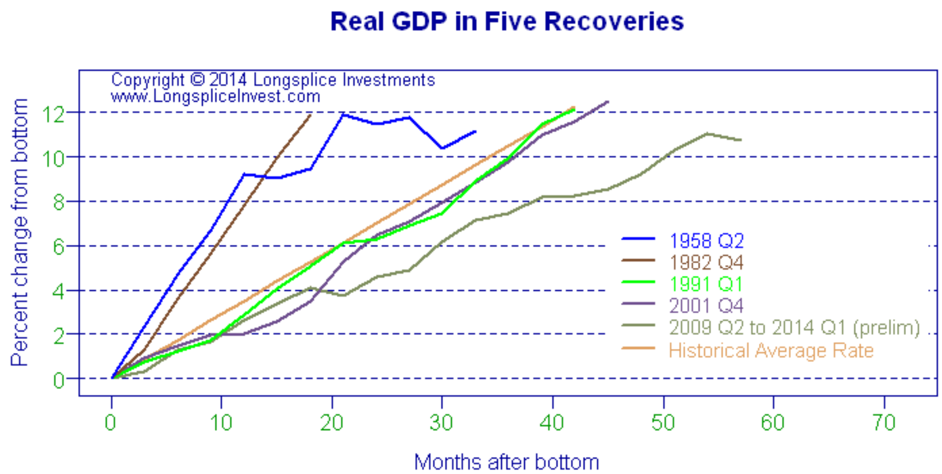
If you're inclined to pick among individual securities, be careful: stick to value, to safety, and call me to chat if you’re concerned about anything you’re holding. At the moment I wouldn't want to be holding bonds. The risk is high and the reward is extremely low.

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:

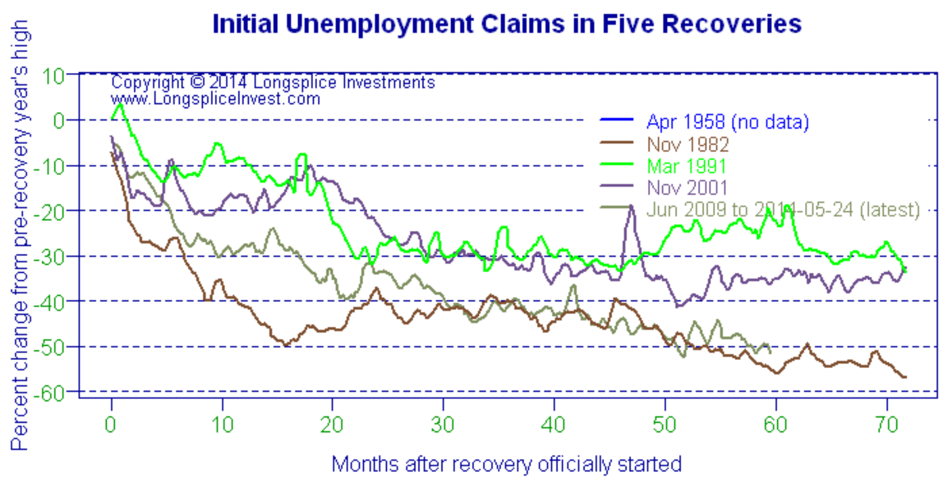
Everything is OK. Not great, but not bad. I'm sticking with the portfolio theme and specific stocks I've detailed in previous letters.

Last month I mentioned that the 'Advance' (first guess) estimate of the **GDP** during the first quarter of the year had been flat. This month the 'Preliminary' estimate shows a small decrease.

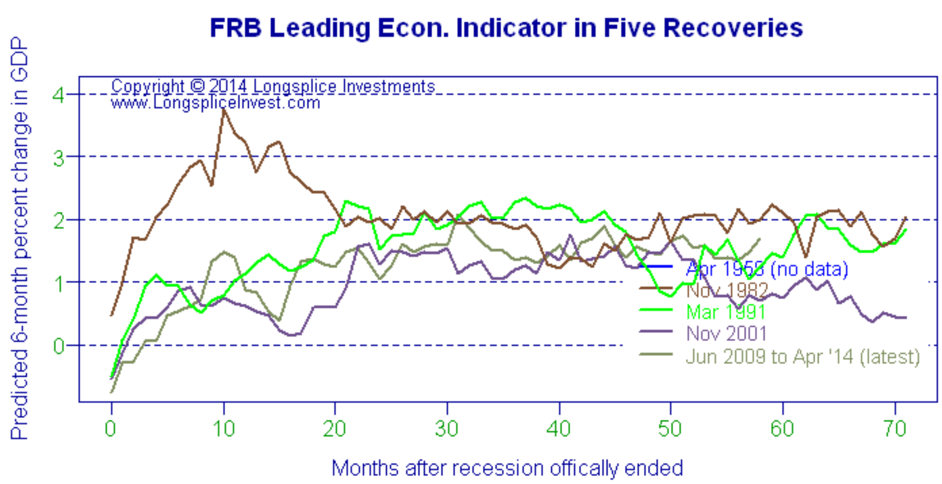


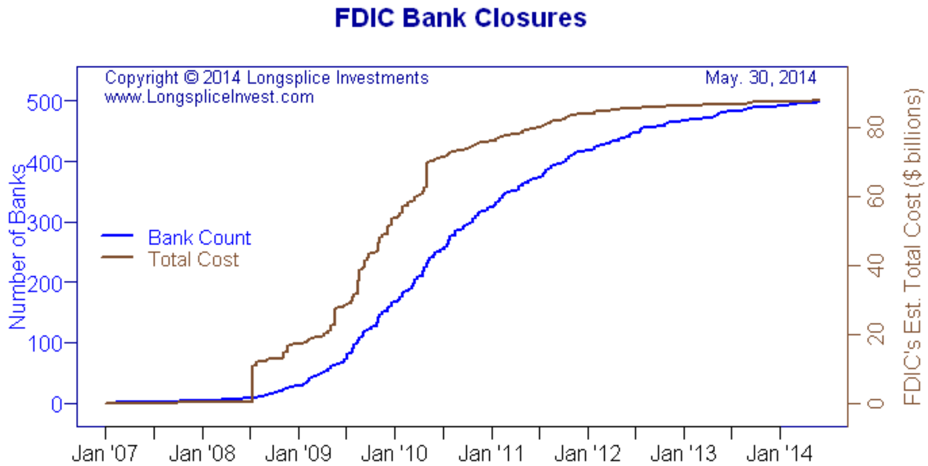
That's certainly disappointing, but it's not a cause for new concern. The reasons for the drop, which still may be revised upward next month, are well-known and one-time problems.

Other recent reports give us much **better news**. The number of newly-laid-off workers dropped again last week, to nearly the lowest level since before the recession.



That and other economic data feed into the Fed's Leading Economic Indicator index, which rose nicely to a better-than-average level for a recovery. We have every reason to expect continued improvement.





The end of the financial crisis period passed a milestone yesterday, as the **500th bank** was closed by the **FDIC**.

Recall that no banks failed in 2005 or 2006. That's the level we want to get back to. The rate of failures and the cost of protecting the insured savings of those banks' customers has tapered off to nearly-- but not quite-- nothing.

The total cost to the FDIC will probably not exceed $90 billion. The cost to the US taxpayer is zero. The FDIC is supported by insurance-like payments from the banks. This is the one part of the whole fiasco where the banks actually bore the cost of their folly.

Last month I mentioned my concern about Pfizer because of their bid for rival drug maker AstraZeneca. That bid generated a lot of political and investment discussion about the tax aspect, the inevitable layoffs, and the relative values of the two companies. Since Pfizer was partially paying with their own stock, the ratio of the 'true' value of Pfizer shares relative to AstraZeneca shares had a big effect on the interpretation of how much Pfizer was paying.

Pfizer's price has not yet come back up to where it was when I wrote that I was selling. I hadn't sold all of mine before the price dropped abruptly. Now I'm neither in a hurry to sell the rest, nor considering buying any back.

Pfizer and most of the other big pharmaceutical companies are having trouble with their R&D. Many of their most profitable drugs are old enough that they will cease to be protected by patents soon. Some new drugs look good, but nothing looks like a real bonanza. That raises the question: what caused the surge of good drugs a dozen years ago, and why did that surge taper off? I assume that the answer is technological: that the developers fully exploited some research knowledge breakthrough, and now lack a promising direction for their search. If that's true, it's a problem that could last a long time. Breakthroughs don't respect schedules.

As an aside, note how casually Wall Street abandoned the idea of an 'efficient market' during the bargaining. If the market were efficient, then the 'true' value of Pfizer and AstraZeneca stock would have been the market price. When real money is at stake, no investment professional believes that.

Last month I wrote a little about how I **choose stocks** to invest in. The idea of choosing at all assumes that the market does not express the 'true' value of stocks. The next question, of course is, "So what makes you think you can see a stock's value better, and what makes you think the market will come around to a 'truer' price."

Those are fair questions. Most of the time I can't offer a good answer for one or both questions. That means I don't single those stocks out to buy or sell.

On the other hand, sometimes, especially when the market is being exuberant, I look at potential investments and think "I really don't want to buy a company with those risks at that price." So I don't. If you're a long-time reader, you'll recall that sometimes I just sat on cash rather than make investments I didn't like.

Warren Buffet has described the same issue during some of the bubble periods during his career. His 'sat-upon cash' was, if I recall correctly, $6 billion in 2004 or -5. That was a lot of money sitting earning very little, which he found frustrating. I certainly don't claim to be as astute or experienced as he is, but his comment does legitimize the concept.

As I said, the basic rule everyone knows is "Buy low, sell high." Sometimes, especially when some investments are getting a lot of attention and prices have been pushed up, the key question is "what's cheap?" If most things seem too expensive for my taste, what is out there that is not an object of that attention, and is that neglect making it cheap?

That was the line of reasoning that led me to the dividend stocks back in 2010. The circumstance was slightly different, in that the stock markets had been driven down by the crowd rather than up, but still the key was "What's cheap: what has value that isn't being recognized in its market price?"

Oftentimes there isn't a clear answer, but sometimes there is.

Timothy Geithner was the president of the Federal Reserve Bank of New York[1] when Wall Street melted down. He helped craft the bailout plan funded by taxpayers, and helped push the plan through a reluctant Congress. Later he was the 75th United States Secretary of the Treasury during the desperately anemic faltering recovery.

He has written a **book**, Stress Test.[2]

I have not read it, but I've heard him talk about it in interviews. It makes my teeth hurt. He is unrepentant, repetitious, evasive, and defensive.

Aside from style, my main objection is his insistence that it was not just a bailout of the financial firms, specifically the big banks. Everything he did, he says, was necessary to protect the working-class masses of America and the world. He seems really put out that we don't accept that definition.

I grant that a bottomless financial meltdown would have been bad for everyone, and preventing such a total meltdown was vital.

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1 "Timothy Geithner," Wikipedia, 22 May 2014 at 21:54, Wikimedia Foundation, Inc., 31 May 2014 <https://en.wikipedia.org/wiki/Timothy_Geithner>.

2 Timothy F. Geithner, Stress Test: Reflections on Financial Crises (Crown, 2014).

However, my question to him is: once the banks were saved, why did you stop? The working-class masses of America and the world are still suffering a-plenty. The damage that the now-rescued banks caused to them is still there. So, champ, where's the rest of your rescue? You're no longer in office, but are working at Warburg Pincus, a (surprise!) Wall Street private equity firm. You were Secretary of the Treasury of the United States for four years. Don't you think you could have at least raised your voice for more help for the non-financier classes while you were there? You didn't, you know.

You still could help if you wanted to. If you take a few free moments from your aggrieved self-defense, you could still offer suggestions, perhaps even lobby, for defending the interests of We, the People.

It's time to email this to you.

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

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