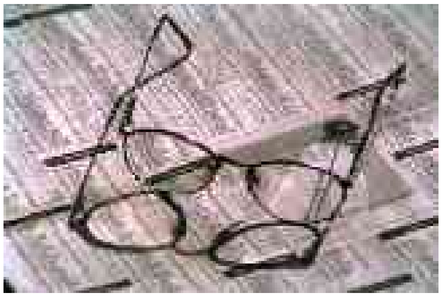
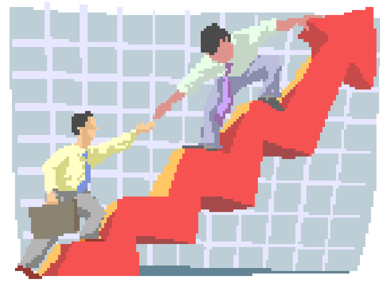


Capital Drain



Rick's investment opinion newsletter June 2005 v.1 no.6

Hi Readers,

I'm still casting about for a new name for the newsletter, something a little less flippant without becoming truly boring.

What do you think of “Balanced Values”? I like the play on words, “balanced” and “value” being jargon for specific types of mutual funds, while “balanced values” tries to imply a search for a rational middle ground.

A close friend recommended that I pick a name that combines searching/discovery with synthesis, combining disparate ideas, and sharing/dissemination. Meanwhile, I’m still thinking.

I'm eager to hear any ideas that pop into your heads.

OK, saddle up & let’s go. In my opinion:

Executive Summary:

Financial Theory: What does it mean when people talk about a bubble? Are we saying that investors en masse are crazy? No, but it does mean that some are over-enthusiastic.

The Dollar: People are saying the Euro is in trouble. Does that mean the Dollar isn’t? No.

Behavioral Finance: The best single predictor of tomorrow’s weather is today’s weather. Most other things are predicted better by longer history, but it’s today’s results that are foremost in our minds.

As before, I think everyone is best off with a broad diversification that includes at least 3/4 overseas assets, reflecting the distribution of world economic activity.

These are not the best of times, so investors need to 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 such as Google, Google, (did I mention Google?) or Taser.

The Details:

Much has been made about the referendum defeat of the proposed European Constitution, and some are now questioning the survival of the **Euro** single currency and other long-standing aspects of the European Union (EU). Is there any validity to these concerns?

No, I don’t think so. I say that for several reasons.

First, on the referenda and the Constitution, I think it’s important to keep perspective. This proposed Constitution would have been a huge advance in the self-set EU goal of “an ever-closer union.” However, not having this new Constitution merely means that the status quo of last year will continue for a few more years. That’s not so bad.

Wasn't there a lot of ranting about how this Constitution was essential, inevitable, irreplaceable, etc? Yes, there was, from its supporters. They can hardly be expected to campaign for it with a slogan like "If you don't like this one, tell us and we'll try again." Of course they painted this one in the most glowing and strident terms.

The Constitution's critics, however, pointed out that this specific document had some serious and avoidable flaws:

- It was excruciatingly long, running to hundreds of pages (http://news.bbc.co.uk/nol/shared/bsp/hi/pdfs/21_07_04cg00086.en04.pdf) depending on the specific presentation. By contrast, the US Constitution without Amendments is just about 10 pages (http://www.house.gov/Constitution/Constitution.html).
- The length was because it was far from a general framework of principles. It spelled out a lot of minute details. By enshrining that level of detail in a constitution, the framers were asking for trouble as modifications became necessary.
- It over-reached the European public's current interest in closer political union. The citizens enjoy, generally, the fruits of the economic union, but they prefer being substantially governed by their own countrymen and customs.

The Economist news weekly has been a champion of creating a european constitution, but an acerbic critic of this specific attempt. They have some very good commentary online at http://www.economist.com/research/backgrounders/displaybackgrounder.cfm?bg=898366&CFID=56579434&CFTOKEN=59204c1-c31360a4-1f5e-43ed-82ca-ed8283b725fc
Sorry about the long URL. You can probably find the same page if you go to http://www.economist.com/ and search for "EU Constitution."

In time, the EU leaders will try again and write a more sensible, realistic, popular version.

In short, this is much to do about nothing, or not much.

The strain on the Euro, similarly, is easy to exaggerate. Germany could use lower interest rates, Ireland higher; Italy would love to have a currency they could devalue freely like the good old days, etc. However, none of these problems is really greater than the benefit that each of these countries gets from the Euro, and these governments know it.

The fall of the Euro relative to the Dollar is just a temporary re-balancing. The Dollar is still going to fall, but not until it can fall against more of the world's currencies at once, i.e., not until there's more exchange-rate flexibility in Asia, specifically in China. That will come, sooner or later.

One of the current tenets of Finance is that markets are rational. By this, theorists mean that the prices are set by more-or-less-mostly rational people whose aggregate informed points of view will "vote" for a satisfactory average price for any good, service, or security. How is it possible, then, for there to be a bubble, as people now generally agree there was in tech stocks? **Is it possible that there could really be a bubble in housing?**

Three things are necessary for a bubble to be able to form rationally:

- Strong difference of opinion. There must be True Believers who are determined that the price should go up a lot, as contrasted with the Mean (a.k.a. Average) observer, who think prices are already about right.
- Debt financing. It is essential that the "votes" of the True Believers be amplified by the multiplicative effect of buying with borrowed money.
- Initial successes. Whether by chance or some small but real insight, the True Believers get rewarded by results—and they reinvest the gain.

As an example from the last bubble, let's pick one dear to me, Amazon.com. They are now a reasonably healthy catalog retailer, with the extra bells and whistles achievable by having their catalog on the Web.

Once upon a time, the Web was new, Amazon was brand new, and the True Believers (recall that they "got it") believed that e-commerce would necessarily vanquish all of old Bricks and Mortar commerce. You may smile now, but you certainly remember that such talk was common.

The people who were talking that talk were buying Amazon like crazy. They thought it was hugely undervalued, even as the value of the company eclipsed Lands End, then Sears, then Target, then even Wal-Mart. The True Believers bought more stock at every opportunity; they thought they had a sure thing.

And in truth, Amazon had some things right, so they could point to small real initial successes. These real successes caused even some of the Mean to buy some of the stock.

The True Believers were thus rewarded, if only a little, for their faith. Did they take profits? No, they doubled their bets. Having bought on margin (50% borrowed money), every dollar that Amazon rose was TWO dollars of profit to the True Believer, which became FOUR dollars of buying power to buy more shares.

So they bought, and the positive feedback loop was closed. More buying brought higher prices, and higher prices brought 4x more buying. Even if the Mean were selling a little, the True Believers had a 4x boost in their "votes" on the stock value. After a while, though, the Mean acceded to the perceived wisdom of the rational market, and bought some too, "just to be safe." The bubble was now securely self-inflating.

What pops a bubble? No one quite knows, except to say that the further you get from "normal" values, the easier it is for a small disappointment to start the avalanche.

Then, suddenly, the borrowing works in reverse. When the stock falls one dollar, the True Believer loses TWO. He may still believe, but his broker or banker doesn't, so the True Believer has to sell to pay off the debt. This can accelerate in a heartbeat, and debt-financed investors can see their gains wiped out before they have time to really realize they're not still winning. The Mean investors, of course, lose a lot, too, just less, assuming they're been conservative in their use of debt.

It all sounds so speculative, if- if- if-, but each of you reading this saw it happen just half a decade ago.

So, could it happen in real estate?

- Presence of True Believers YES
- Debt Financing YES
- Initial Success YES

Yes, it could happen in real estate, and it probably is. When you read about the people re-selling unbuilt condos, and neighbors using a refi on their home so they'll have the down payment on an investment property, and people taking on more and riskier debt relative to their real estate value, confident that prices can only go up, … well, that's what a bubble looks like.

What will pop it? No one knows. When? That's even harder. But if it's a bubble, something will pop it, sometime.

Many people have said that housing is different, that people won't rush to sell but will hold their homes. Ordinarily, yes, but when there's a lot of speculative "investment" buying and a lot of right-to-the-edge financing, NO. People who are way out on a debt limb could easily be forced to dump real estate onto the market, and any sharp drop in prices would lead to a selling panic. Bear in mind, at the first whiff of lower prices, most potential buyers would just sit on their hands and watch.

It would not, almost certainly, be like the 90% fall of the NASDAQ after the stock bubble. Still, in some markets, a 30% drop in a breath-takingly short time is possible. For the Mean investors, the old-fashioned kind who just bought a home and put 20% down, that wipes out their equity. No worries, as long as they can stay put. If they have to move, or if the balloon comes up on their mortgage, or if their ARM rises beyond their ability to pay… the problem with bubble bursts is that the pain gets spread pretty broadly.

It wasn't so long ago that people considered large amounts of debt to be dangerous. It hasn't seemed dangerous at all for a while, and that brings us to the Behavioral Finance concept of the **Availability Bias**.

Almost everyone who has bought a house in the last few years, even the True Believer speculators, has heard of the Great Depression, and of other events when debt was dangerous. But to them, that was then and this is now. History can even be explicitly acknowledged, but not given any weight compared to the present experience. When they think of debt, or of house prices, the ideas which are most available, which pop into their heads, are the recent ones.

This bias works in many ways: people are scared to fly after a plane crash, but only for a few months. They stop eating beef after one positive Mad Cow Disease test, then slip back into their old eating habits when they're distracted by some other threat.

The availability bias is a central part of what makes bubbles work, and what makes some people think that the Euro is suddenly in trouble and the Dollar never could possibly be.

It isn't bad, it's just human. All we can do about it is to try to be extra-reflective when we're doing something that potentially has big long-term consequences. Are you investing in stocks or real estate? Don't get caught up in the mood of the moment. If big sums are involved, sit down and think about history. You don't have to rush your judgment, and you just might be happy that you paused to reflect on the less-available wisdom of previous eras.

It's time to wrap it and ship it.

If you have any questions, please please write or phone. If you want to read more, I've got a web site with old editions of this letter and some links to other interesting sites.

Please feel free to forward this to any friends or associates who may be interested.

For those of you getting this sample gratis, I charge $120/year for this newsletter. If you're not sure you like it, you could subscribe for 3 months for $40. Your checks, mailed to the address below, are always welcome, will be appreciated, and can be claimed as a tax deduction as an investment expense.

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
