Capital Drain

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Hi Readers,

I've graduated. Whew.

What I'm up to now is rather a bit different than what I went into the MBA program thinking I'd do, but there's a reason and a rhyme to it.

The new plan is a mutual fund. I definitely have some homework to do to prove to myself that the idea is sound, but here's the outline:

- Yes, a mutual fund, SEC-registered and everything.
- The investing style will be more fundamental and less macroeconomic-oriented than this newsletter has been.
- Differentiating features:
  - Long and short stocks. Yes, mutual funds are allowed to, but few do.
  - Socially responsible investing: It would be OK to short Halliburton, but not to buy it. :)
  - Highly performance-oriented fee structure
    - No load or 12-b-whatsit fee
    - Tiny or no fee if performance is below a (TBD) benchmark
    - A significant share of the excess performance
    - In short, a hedge-fund-like fee structure

Some of my classmates have asked me to start a blog describing the process of putting this thing together. If I figure out how, I will, and I'll mention it in some future letter.

I STILL need a better name. I may have to gather my Marketing buddies from school and ply them with white wine until they think of something.

OK, let's write a newsletter. In my opinion:

Executive Summary:

Macroeconomics: This is turning into Ben Bernanke's worst nightmare, and Alan Greenspan probably understands that he retired just in time. It's not the 1970s, but inflation plus recession is Stagflation.

The Dollar: The markets have had their little fainting spell. The dollar has resumed falling, gold has resumed rising.

Oil and Politics: It's as if Bush is double-dog-daring the world to drive the price of oil above $100/bbl. There are many countries that could, and a rising chance that one will.

> As before, I think everyone is best off with a **broad diversification** that includes at least **3/4 overseas** assets (easily purchased via US mutual funds), 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 high-PE stocks such as Amazon, Google, Whole Foods, or Taser.
>
> Sure, Google is doing great. So was WebVan once upon a time. Google's a pretty good company, but at the current price you could only buy based on the Greater Fool Theory: "Sure, I paid too much, but I'll find a Greater Fool to whom I can sell it for even more!"

The Details:

For most of the past 30 years we've been used to the standard **economic cycle**: a boom builds, inflation rises, the Fed raises interest rates, there's a slowdown or recession, inflation falls, the Fed lowers rates, repeat. The Fed would like to be able to fine-tune better so that the peak-trough height of the cycle is smaller, but basically everyone is pretty comfortable with the way it works.

What would happen, though, if the cause of the inflation didn't respond well to rises in US short-term interest rates? Suddenly, the Fed is uncomfortable.

At the moment, there are two big things feeding inflation:

- Lots of excess liquidity (excess borrowed cash available) from years of interest rates having been held too low in the US and in Japan. This allows those who have the cash to bid more for scarce resources like land, metals, or energy.
- Oil, a crucial input to our modern way of life, doubling and re-doubling in recent years, raising the cost of making and transporting everything else.

The first of those reasons is like the "classical" inflation. Raise rates for a while, and the excess liquidity will be decreased. Less cash means less upward pressure on prices.

The second reason, however, is more like the '70s oil-induced inflation. US interest rates won't lower the price of oil unless the rates are raised long and hard enough to cause a significant worldwide recession, significant enough to substantially decrease world appetite for oil.

Whichever Fed Chairman has to solve that second inflation problem will be extremely unpopular at the time, just as Paul Volker was in the early 1980s. That history remembers Volker as brave and strong did not make it easier for him while he was doing the difficult work.

Ben Bernanke would very much prefer not to have to do that work, but he may have to (or be remembered as neither brave nor strong nor bright.)

Alan Greenspan helped create half the problem (the liquidity part) but won't have to be the bad guy who cleans it up.

Paul Volker has retired, but is doubtless available for advice.

Note, if we do have a really big, bad recession, then stocks will suffer, not just in the US, but worldwide. Why worldwide? Because the US has become the favorite target importer for all the countries that want to develop by exporting. If the US consumer stops buying, everyone will have to stop selling.

Meanwhile, everything I've been harping on about the **dollar** is still true. I could say it again, but instead if you want a recap you can read some of the previous issues of this letter. In summary, it will fall, or continue to fall. Just recently the dollar has slipped below 8 Chinese Yuan for the first time.

If stocks are suffering everywhere, and the dollar is falling, what's left for an investor? Foreign government bonds are pretty attractive now. Stick to the bonds of the big old boring countries with big old boring economies.

Oil. Have I mentioned that I question the President's sanity? Yes?

I could almost believe that W has made a list of the big oil exporting nations and asked his staff to develop plans to make 2/3 or more of those nations mad at us.

The President's Press Secretary would counter that 2/3 or more of oil-exporting nations are mad at us because of a coincidence, or because of Liberals or the UN or gay marriage or the EPA. OK. Whatever.

The point is that there's only about 2-3% excess in the entire world in capacity to pump oil each day. That is, if everyone cooperates, they could pump about 2-3% more oil than everyone consumes.

There are several, actually many, countries which are mad at us and which pump more than 3% of the world's oil output each day. If any one of them decides that it's mad as hell and it's not going to take it any more, and stops pumping oil, then... there won't be enough oil each day. The price of oil will skyrocket. The Strategic Reserves are not big enough to make up for several percent of missing capacity.

Venezuela, Iran, Nigeria, Russia. Is this a list of countries you would choose to depend on? No? And yet you are, every day, depending on them to keep selling us oil, even though they don't particularly care for our policies.

I don't find this situation very appealing, but if you have faith that the Bush Administration has developed a careful, thorough, realistic, long-range plan for the scenario (they always have before, right?) then you can sleep easy.

It's time to cut this rant off and email it out.

If you have any questions, 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 who may be interested.

Take care,

Rick

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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
