Capital Drain

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Hi Readers,

I'm still working on my mutual fund idea, and I hope to have it rolling out this summer.

Why should the country need another mutual fund, when already there are more funds than there are stocks? (Amazing but true!) Said a different way, what do I propose to offer that is different from all the others?

What I propose:

- A fund that harkens back to the early hedge funds: buy the best stocks, and short the worst. In that way, the overall portfolio gets substantial (not perfect) protection against the entire market going down. As long as the best stocks fall less than the worse stocks, the fund profits from the increased price difference. Similarly, if the entire market goes up, the fund would miss some of the gain of the entire market's rise, but it would still gain if the good stocks went up more than the bad ones. In summary, the fund would achieve a good, relatively steady gain, without the thrill of the big market rises, but also without the agony of the big market falls.
- An incentive fee structure in which I don't get paid unless I make you money.
- Apply socially responsible investment screens. You, and many other investors like you, have values that define how you think companies should behave: respectfully and responsibly toward the environment, the workers, the shareholders (!), and society at large. By not buying the stocks of bad corporate citizens, the fund can make sure that your money works for your values.
- Curiously, after all these years of writing a mostly macroeconomic-focused newsletter, the mutual fund idea won't do that much at all. Its focus will be US stocks, across the entire economy, with relatively little macro thinking affecting the individual stock evaluation and selection.

What I still need, most of all:

- A name. When you read the description above, what sort of images came to your mind? Please send me an email with your thoughts, to CapitalDrain@Ricks-Cafe.net . Thanks.

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

Executive Summary:

Inflation is not dead
Housing is not rebounding
The economy will probably continue to bumble along
Earnings will not
The stock US market could be brutal in its disappointment

Meanwhile, the dollar will fall
Overseas economies will be OK as long as the US economy is at least OK

Behavioral Finance: the illusion of control.

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 and Exchange Traded Funds (ETFs)), reflecting the distribution of world economic activity.

This is a good time for investors to be conservative, 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 with high P/E ratios.

The Details:

The warm early winter (for some of us anyway) has passed, and the cold weather has increased energy demands and hence oil prices. Even though prices for oil and many other raw materials are below last year's peaks, they are still well above a year ago's level. That price rise is working its way through the logistical pipeline, and continues to slowly press retail prices upward.

In addition, skilled workers are becoming scarce in some areas, pushing wage rates up. While that has a good side, since we want our fellow citizens to (albeit belatedly) get a share of the improving economy, still the bad side is that that's another upward force for prices.

In short, inflation is not dead. It's not terribly high, either, no cause for major alarm, but it is higher than the Federal Reserve wants it to be. That means that interest rates will likely stay high for a while yet. Depending on the details, they may even be raised just a bit more, but probably not. The good news here is that you get decent returns on your money market accounts. The bad news is that mortgage rates will stay high.

Those mortgage rates are some concern to all of us, even if we're not in the market to buy a house. The overall national housing market is still falling, and mortgage rate decreases are not going to come to the rescue. There are many pundit cheerleaders who seize on every least bit of good news to trumpet that housing is rebounding. Housing is not rebounding. The bulk of the data still show that sales are slow, prices are crumbling, and there are a lot of empty houses-- excess inventory-- still on the market.

Lower house prices can, to some extent, affect the behavior of people who aren't even considering selling their houses. Lower prices mean that it's harder to take cash out from a mortgage refinancing. In the past decade of rising prices, cash-out refinancing has contributed a lot to consumer spending. That source of "income" is drying up. Even people who aren't refinancing may realize that real estate appreciation alone may not create the wealth they will need to retire comfortably. Those people can be expected to eventually, grudgingly, spend somewhat less and save somewhat more. That's good for them, but it decreases the growth of the economy, which is quantified as Gross Domestic Product (GDP.)

The end of the home-building boom also decreases GDP directly: home builders are finishing the projects they've started, but they aren't starting more. A handful have gone bankrupt; most of the others are cutting back their labor force and their spending on materials. Here again, it makes sense for them, but it decreases GDP.

Will these drags on GDP cause a recession? Could be, but at present I tentatively doubt it. The economy will probably continue to bumble along. I say that with some puzzlement, since (as I discussed in previous months, see back issues on the web site) the Index of Leading Indicators has been falling for quite a while, and has fallen quite a distance. Also, the interest rate yield curve is still inverted (again, see previous issues). The longer it stays inverted, the higher the statistical likelihood of a recession within 12 months.

Some TV pundits have suggested that we can't see a recession starting with unemployment so low. That turns out to be historically mistaken. Employment usually lags the economy, that is, the employment can keep falling even after a recovery has begun, and also keeps growing even as GDP slows and slides

The stock market has been bouncing up lately, because corporate earnings have reached record high levels, not just in dollars but also as a share of GDP. That may be about to end.

Typically, in an economic recovery profits increase very quickly at first as companies get reorganized and get their sales back up to near their capacity. After that, though, profits reliably level off and then decrease. The easy growth has gone. New competitors arrive. Expensive new factories or stores or offices have to be built. All this drags down profits.

As profit growth falls-- mind you, I'm not saying profits have to fall, just that the growth rate of profits falls-- then the stock prices can start to look too high. Investors will tolerate/ignore that for a while, but eventually they'll get nervous. When they start to sell, the decreasing stock prices can cascade, as other nervous investors follow.

Broadly speaking, that's the typical pattern of GDP recession and recovery, dancing in a loose embrace with profit growth and flattening, which also lead the stock prices' rises and falls.

I think this year could be pretty sharply disappointing for the US stock market.

Meanwhile, this wouldn't be my newsletter without me saying that the dollar will fall against most other currencies. There's been a bit of a bounce for the dollar this past two months, but I think that's just the usual end-/start -of-year trading aberrations. The trend will resume, slowly and steadily unless something big goes wrong, in which case it could be nasty, brutish, and short.

That makes overseas investments attractive. In the last year Europe's economy has improved remarkably, Japan may finally recover after dozens of false starts, and India, China, and the other Asian developing countries are becoming somewhat more independent of selling to just the US. If any big player in the world has a big recession, it will affect everyone. I don't think that is likely, though. Overseas economies will be OK or better as long as the US economy is at least OK.

I heard an interesting conversation the other day that illustrated the Behavioral Finance concept of the illusion of control. The speaker was describing how he now picks individual stocks himself for his investments, because he'd been badly burned by having his money in mutual funds during the burst of the tech bubble.

I'm sure the burst was painful for him, and I don't want to belittle that. However, what he described as his method for picking stocks was neither sophisticated nor systematic. From an objective, realistic, outside perspective he would probably be better off still invested in mutual funds.

From his psychological perspective though, he feels better now because he is being proactive, taking control, not just watching something happen to him. So far his results have seemed pretty good to him, but he's been investing during an economic recovery and a rising market. The good results are not coming from his increased control; they're coming from the improved environment. If things turn bad for the market, he is likely to be in for a depressing, confusing, painful experience.

Don't get me wrong-- it is possible for a knowledgeable investor to do well. It takes a lot of knowledge and time and consistent attention, though. For people without all three of those factors, broad-based mutual funds are overwhelmingly likely to be a better investment.

For the fellow I discussed, a better compromise might have been to limit his increased activity to a periodic decision to be in the market (via a fund) or be in cash (a money market fund). He would gain his sense of control, while limiting his scope for messing up. If he wasn't able to decide to jump out of the market during the two-year protracted slide of the tech debacle, he probably can't do better by trading more idiosyncratic individual stocks based on the ebb and flow of normal business news and luck.

It's time to wrap it and ship it.

- Don't forget-- I'm looking for a name for my fund company!

If you have any questions, please write or phone. If you want to read more, I've got a web site with years of 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.

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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
