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# Policy Matters, Now Profit From It

By **Russell Redenbaugh & James Juliano**

As a follow-up to our previous piece on absolute return, we will now show you one of the ways to make money when others are not. Investors must expand on our absolute return approach to investing and use changes in government policy to direct investment across multiple asset classes.

Understanding government policy is the best way we know to see and anticipate changes in asset values; not merely stocks, but also bonds, currencies, real estate, commodities and foreign markets. Changes in policy impact the economy by altering the supply/demand for products, labor and capital. This in turn changes the relative supply/demand for stocks and other asset classes.

For example, simple economics says if you tax something you get less of it, and if you subsidize something you get more of it. Consequently, an increase in the capital gains tax rate decreases the value of stocks, while a government subsidy requiring that cars use ethanol fuel increases the price of ethanol.

These examples are clearly understood in the framework of basic economic theory. However, what is often misunderstood, especially by investors, is that policy changes often have large ripple effects in ancillary areas and asset classes. Henry Hazlitt taught that all of economics can be reduced to one lesson, "The art of economics consists in looking not merely at the immediate but at the longer effects of any act or policy; it consists in tracing the consequences of that policy not merely for one group but for all groups."

It is now clear that implementing a government ethanol policy several years ago had a considerable impact on driving up the price of not only ethanol, but corn, food, farmland, fertilizer, tractors and farmers' incomes. Investors must understand that the impact of policies can be enormous and far reaching. Small changes in one area can cause very large and unanticipated changes in another.

Not only is it a fool's game to invest for relative returns, but it is also a fool's game to invest in only one asset class, like equities. Investors must use a multi asset class investment framework, not only for diversification, but to fully understand and capture investment opportunities.

## **Which policies are important?**

Every single government policy, even down to the local approval of a park, has some far-reaching impact on supply and demand. We break the policy world down into four domains. By examining what is happening in these four broad areas we can make assessments about which asset classes will provide opportunities for positive returns.

**Monetary** - Monetary policy encompasses all things Federal Reserve. We are believers in Milton Friedman's teaching that "inflation is always and everywhere a monetary phenomenon." Therefore, the actions of the Federal Reserve will always be inflationary, deflationary or neutral. This will have large and differing affects on asset classes.

Since well before 2007, the Bush administration's Fed was running an erratic monetary policy. The current deflation did not truly end until around September 2008 when the Fed began adding excess monetary base to the system. This should have marked the end of the asset price decline, and in some asset classes it did. As the Fed's monetary base expansion began and accelerated, collapsing spreads and improving credit market conditions sparked enormous rallies in asset classes like municipal bonds, investment grade corporate bonds and precious metals. An investor who ignored the impact monetary policy had on these non-equity asset classes missed some extraordinary opportunities for return.

**Tax** – Tax policy encompasses taxes on personal income, capital, dividends, businesses, interest, and death. We believe incentives matter, and tax rates change behavior. Importantly, the incidence of a tax can be different from the burden. The Obama administration is clearly hostile towards wealthy individuals, shareholders, estates and businesses, especially Wall Street.

We have no doubt that they will raise tax rates in all of these areas, and the recently released budget outlines the magnitude of some of those increases. These rate hikes are not merely to increase revenues, but to execute their fundamental goal of changing social policy through the tax code. They believe wealth is a consequence of unfairness. Just as monetary policy determines the inflation rate, tax policy determines the operating rate. No matter how high the spending “stimulus,” higher taxes will result in downward pressure on income, output and employment.

**Trade** – Foreign trade is the visible side of international capital flows. A trade deficit must mean a capital surplus, and any country that imports capital must run what is called a trade balance deficit. Foreigners must sell us their products to earn the dollars to buy our titles to capital - our bonds, stocks and buildings.

We believe that this free flow of capital and trade is the voluntary exchange by which the entire world becomes more prosperous. Capital markets cannot work if product markets fail to work through open trade. Obama campaigned on a platform of protectionism and is now delivering on his promises with tough talk against NAFTA and the inclusion of “buy American” provisions in the “stimulus” bill. If we want the world's capital, we must take their products. Impeding that process is something we already tried...it was called the 1930's.

**Regulatory** – Regulatory policy specifies outcomes that would not be produced by the markets. Some of these can be very useful, like food safety standards, seat belts and standard size rail gauges. We believe that regulation is beneficial, improves commerce, facilitates trade, protects both buyers and sellers, and can strengthen markets.

However, central planning derails the economy. This happened in the Nixon/Carter era and is threatening to happen again. Disastrous regulations imposed by Bush, like mark-to-market accounting rules and the elimination of the uptick rule, continue under Obama. These policies are worsening the financial crisis and adding uncertainty to markets.

The mother of all regulation lurking out there is cap and trade. Based on questionable and unsettled science, cap and trade will dramatically increase energy costs, lower output, increase unemployment, and cause carbon intensive manufacturing to shift out of the U.S. What's more, closing our borders to the importation of those products will collapse our capital markets. This is not a prosperity friendly policy. We should not sacrifice our economy for uncertain science. We need more data.

## **How to Invest?**

Watching policy tells you not only when to buy/sell, but what to buy/sell. While we think the Bush financial crisis is ending, the Obama central planning crisis is beginning. Our read of the policy landscape has us positioned in the following asset classes.

Remember, in our absolute return approach we do not care about relative results. Our default is 100% invested in risk free Treasury Bills and all other asset classes must compete to pry investment capital away from cash. We do not have to own anything and only put capital at risk when we expect a positive return. We never “play to lose less.”

**U.S. Equities** – A perfect storm of Bush administration bad policies created the 2008 financial crisis. The Bush administration continued terrible Fannie Mae and Freddie Mac regulations. The Fed botched monetary policy by keeping rates too low for too long, then too high for too long. Then in 2007, after there were already signs of trouble, the Administration implemented mark to market accounting and removed the uptick rule, shattering trust in the banking system.

The final straws on this collapsing camel’s back were allowing Lehman to fail, beginning the process of bank socialization and being unclear about uses for TARP funds. The financial panic was mostly solved by the Fed’s bold and aggressive action. The Fed correctly flooded the system with excess monetary base, thus ending the blackout in credit markets. So why are equities at new lows? Because equities are not pricing the end of the Bush crisis, rather they are forecasting the upcoming Obama crisis.

Equities are titles to capital and very long duration assets. In this way they differ from other asset classes like bonds, which are a stream of payments on a fixed schedule for a time certain. Equities are ignoring stimulative monetary policy and instead are looking ahead at the worsening policy landscape in the tax, trade and regulatory domains. Policies in these areas are anti stock market. We have reduced our equity exposure from over 80% in 2007 to around 30%. We intend to further reduce equity exposure so long as policies remain hostile towards shareholders.

**Fixed Income:** Almost no other asset class tells the story of our policy and economic situation better than U.S. Treasuries. During the October/November panic, T-bills traded at 0% as investors fled risky assets. This pushed longer term Treasury bonds to unsustainably high prices. We were happy to sell all Treasury bond holdings and move out the fixed income risk curve.

On the heels of stimulative Fed policy we invested in municipal bonds and investment grade corporate debt. These areas have rallied over 20% from their October lows and, unlike equities, held onto most of those gains through today. Lastly, we invested in Treasury Inflation Protected Securities (TIPS). We see a perfect storm brewing for inflation as the Fed supplies excess money while Obama’s “stimulus” and tax hikes collapse GDP. This is textbook “too much money chasing a shrinking supply of goods”, and it’s reminiscent of 1970’s inflation.

**Commodities** – The same inflation scenario pushing us into TIPS is also pushing us into hard commodities. Precious metals prices are mostly influenced by their nearness to money. Other industrial and agriculture commodities prices are determined by an inflation

component plus a supply /demand component. We have a small investment in gold and gold mining companies as a direct play on higher inflation. So far we have stayed away from softer commodities like energy, agriculture and industrial metals whose sustained price increases will also require an increase in economic activity. As in all of our investment decisions, we are not trying to call a bottom.

**Real Estate** – House prices are not too high, but they are falling. Measures of affordability indicate that houses are as cheap as they'll get...until next month. The Administration is so far failing to grasp the idea that the “just one thing” to fix many of the economy’s problems is to stop the house price decline. We are watching for policies that will restore real estate markets to their normal state. Only then can we begin viewing real estate as a valid asset class for investment. We see no reason to be early into homebuilders, REITS or housing sensitive investments. When the time comes, there will be excellent ways to invest in this important asset class.

**Foreign Equities** – It will be very difficult for most foreign markets to do well if the United States does poorly. The U.S. is the world’s customer, and no entity can do better if their customer does poorly. Success in foreign markets is connected to growth and stability in the U.S. When U.S. policy improves there are many dynamic and innovative foreign economies that will represent attractive investment opportunities.

Counter intuitively, when the U.S. begins to imitate China’s and India’s tax cutting and pro business policies, this will be the moment to invest. Their young workforce demographics are a perfect counterbalance to our older, pre-retirement population. Demography is the only destiny that is inescapable. Investors will want to be positioned for the rising prosperity of 40% of the world’s population.

## **The Future**

Like so many things in life, our investment strategy is easier said than done. Investors often get trapped into certain asset classes and styles. This is so common that the entire investment industry is arranged in this manner.

There are managers and funds for large cap growth, small cap value, high yield foreign bonds and countless more. They all promise returns based on long term reversion to the mean analysis of their style or asset class. However this boxed thinking limits their observations and prohibits them from using a larger, worldlier lens to shape investment decisions. Many investors know that policy influences the markets, yet they are unable to capitalize on the range of asset class opportunities. Their underperformance continues.

Investors must take a bolder approach. Focus on an absolute return strategy. Diversify across multiple asset classes. Stay tuned to timing. Be risk averse with the default portfolio in cash. This has and will continue to produce attractive returns with very modest risk of loss.

In the face of negative and worsening polices we outlined above, is it time to give up? Far from it. Now is the time for action. We believe the “just one thing” for successful investing is the ability to make assessments, regardless of the direction of their price impact. As policy improves, very large returns can be anticipated due to today’s extremely low valuation levels.

While we don’t know when policy improvement will collide with these attractive valuations, we will be ready for it. In the interim we won’t be holding and hoping for stocks to bottom.

We will be “Reading the World” to assess where the policy winds create investment opportunities. To not do so is truly a fool’s game.

*Russell Redenbaugh, CFA and James Juliano are portfolio managers for Kairos Capital Advisors LLC ([www.kairoscapitaladvisors.com](http://www.kairoscapitaladvisors.com)). Redenbaugh has built a 40 year investment career learning that the best way to build wealth is through anticipation of changes in government policy.*