PCM Consulting

A Model of Failure

Over the past 18-24 months we have warned of turmoil that was building and is paralyzing the economic and investment markets globally. We have also described investment themes that will have prominent roles going forward. Capitalism and capital are under attack globally. At first blush our view seemed dour and considered to be an unreal event. As we sit here today our view may still be considered dour but is also is becoming very real. Currently, the eyes of the world are riveted on Europe and particularly on Greece, Spain and Italy (at least today). The HOGs (Heads of Government) have failed to be honest with their citizenry and to paraphrase Margaret Thatcher; they have simply run out of other people's money to spend. The outcry over austerity is growing despite the fact there is no evidence that austerity programs have yet to begin. Unfortunately global unrest is rising. The Middle East with its new elections has seen turmoil grow in Egypt and Syria while Iran is testing the patience of the world as they proceed to build nuclear capabilities. In the U.S. the November Presidential election is heating up and despite being nearly five months away we are seeing signs that the Obama campaign has hit the panic button. The Obama re-election strategy has turned sharply to divide the electorate and buy their votes with more borrowed money. Congress refuses to come together to help repair consumer and business confidence in a positive way as they instead hold nonsensical hearings on whether Roger Clemens, a professional baseball player lied to Congress (How about that for irony.) Or trying to humiliate Jamie Dimon of JP Morgan (They failed) over trades that lost fractions of the bank's profits and as an excuse to add more overwrought regulations to kill any part of the economy that may still have life left in it.

All of the actions demonstrate the failure of models. Globally governments, regardless of the level of debt, are addicted to the old (failed) Keynesian model that economic growth is only attainable by pushing the lever of public spending. In Europe, that is the prevailing view with the lone exception of Germany or more precisely Germany's Chancellor Angela Merkel who has steadfastly refused to provide German taxpayer money to failing countries without a commitment to discipline spending. As seen in Table I., the debt to GDP ratios of 6 of 17 euro currency countries are hovering around the point of economic no return (Debt:GDP > 80%). Still being ignored by the press, politicians and in large part investors is the fact that the U.S. may have crossed the Rubicon. President Obama and the Democrats in Congress have also jumped onto the Keynesian carnival ride with a firm belief only the government can create economic growth. Democrats are running ads against Mitt Romney claiming he is out of touch. Given what we have seen to date by the President's action he is not only out of touch but may be on a different planet. Both here and abroad the Keynesian model is being pushed by noted (although not noteworthy) economists like Paul Krugman, Joseph Stiglitz and Jeffrey Sachs. Two Nobel Prize winners (Krugman & Stiglitz) and one an adviser (Sachs) to Russia in the early to mid 1990s . It should be mentioned Russia suffered a major financial crisis in 1998 in the aftermath of Professor Sachs advice. All three have pushed the Keynesian model based on their number crunching in the vacuum of an academic environment which runs counter to the reality we are facing.

Jamie Dimon handled himself admirably in Congress as he never laughed at any of the Congressional questioners no matter how ridiculous or misinforned their questions were. We have the utmost respect for Dimon as he was truly the one grown-up in 2008 when the crisis hit the fan. JP Morgan's loss may have been less a case of risk taking than the failure to be able to accurately quantify risk. Their reliance on a Value-at-risk model (VaR) proved to be their downfall. VaR is another mathematically precise model that uses historical data to determine the maximum amount of capital at risk in today's economic environment. Unfortunately for JP Morgan, Mr. Market is a "C" student in math and not a big fan of history.

Table I. Eurozone Government Debt -2011 % of GDP

Greece	Italy	Portugal	Ireland	Belgium	France
160.8%	120.1%	106.8%	105.0%	98.5%	86.6%

100%

U.S.

Source: Financial Times

Despite the noted failure of the Keynesian model and VaR model, investors still cling to another mathematically precise model, Modern Portfolio Theory or MPT. In less than 10 years investors have suffered enormous losses in 2001-02 and 2008 at the hands of MPT. All of the careful calculating of risk and diversification are no match for the cruelty of the markets as the asset classes correlate to 1.0 under distressed times.

Investors are being set-up for another unpleasant ride. The central banks are holding real interest rates around zero, real estate is searching for a bottom and commodities are selling off which is causing some poorly thought out directives that the U.S. equity markets are attractive and ready to rally. The most common logic and we believe it to be true as well is that the troubles of the Euro, Greece and Euro debt are well known issues and is unlikely to produce any more surprises. What is less discussed is the reality that there will be substantial blowback to U.S. companies as a result of shrinking Euro economies. U.S. corporate balance sheets are strong, profit margin are high and stocks are trading hands at 12-14 times projected 2012 earnings. The underlying reasoning for each paints a different view of the future of U.S. equity markets. Balance sheets are strong because companies have hoarded cash and re-structured debt at historically low rates. Profit margins are near historic high and are unlikely to be sustainable and will regress to the long term average. Leaving aside that forecasted earnings are most likely to be revised downward; stocks at 12-14 times earnings may be considered good value but they are by no means cheap. If one goes back to 1920 or 1931 or most recently 1982 for similar markets and issues, the P/E ratio was between 5-10 times. One final point on earnings is that the high profit margins and decent earnings for the past several years are the result of cost cutting measures and restrained measures rather than revenue growth. The probability that trend reverses is growing while the outlook for top line growth given the economic sluggishness is restrained and not overly optimistic.

Until the global economy bottoms and politicians are either forced to deal with the problems (or forced out of office) the bond and equity markets may be unkind to capital preservation and wealth. These are extraordinary times which may call for extraordinary measures. Two of the most prudent approaches to address investing in today's environment maybe the much maligned hedge funds and private equity asset classes. The immediate reaction is "they are too risky". We would argue that nearly any investment can be too risky under given circumstances and that includes sovereign debt.

First, let's examine hedge funds. There are literally thousands of hedge funds charging fees, on average, of 1-2% on assets under management and 10-20% of profits providing mostly lackluster returns. An investor however needs to find a fund that has a repeatable, sound process and the investment talent to make money on the long and short side of the market. The investor must also come to grips that their risk is not reduced if they invest in a large fund with decades of a track record. They are in most instances greatly disappointed and many times poorer for the experience. Smaller funds of recent vintage have the investor and fund manager's interests aligned which is to make and preserve money and are quietly nimble. These funds must be carefully selected but will provide the capital protection that hedge funds were designed to be. Many investors make the fatal mistake of choosing a manager solely on returns from what prove to be leveraged; long only trading vehicles. Top managers are able to produce alpha in good and bad markets. Most importantly today, they have the ability to protect capital in these very uncertain markets. Additionally, hedge funds can be considered a separate asset class but they provide the flexibility to act as unique investment vehicles that provide upside opportunities and downside protection in all traditional asset classes.

The next potential target for investors is private equity investments either direct or through a fund. We will stipulate that investments in private equity are inherently less liquid. These companies whether a start-up or a re-structuring and everything in between can operate in the best interest of investors without worry of public market pressures or short-term earning releases. Companies in the small to mid-market range are in need of capital to expand there businesses. They have been virtually shut out by banks who have found it more politically expedient and prudent due to new regulations to buy zero percent treasuries instead of lending to sound businesses. The valuations of many of these firms are near lows and when the recovery comes they will be well positioned to provide solid returns. And for investors desiring a stream of income, some private equity debt deals offer multiples of what a treasury or corporate bond yields and many are senior securities and collateralized.

Table II. Historical Index Comparison

	1 Year	3 Year	5 Year	10 Year
US Gov/Corp	5.80%	5.65%	5.88%	5.20%
S&P 500	2.11%	14.11%	-0.25%	2.92%
DJ REIT	9.37%	21.64%	-2.04%	10.12%
DJ-UBS Commodity	-13.32%	6.39%	-2.67%	6.63%
Cambridge Private Equity	**10.90%**	**15.03%**	**7.22%**	**12.02%**

Source: PIMCO & Cambridge Associates LLC

As seen above in Table II., the returns in the private equity sector have produced higher, more consistent returns over all periods indicated. The main drawback is liquidity. In some of the larger PE funds, the life of the fund may now be 9 years or longer. An investor must be fully aware of their timeline and whether that fund fits its profile. Returns should not be the primary overriding factor and investors need to be very cognizant of fees. Another approach might be to be a direct investor in a particular company however there is extensive analysis needs to be completed before nay investment should be made. The analysis is quite similar to any extensive analysis that should be done before investing in any single company in the public market as well.

One additional potential advantage to private equity is the almost ravenous appetite for more taxes globally. Above and beyond the normal marginal rate and capital gains and dividend arguments we are now hearing the euphemistic “Robin Hood tax”. This is nothing more than a high-minded attempt to re-distribute wealth to the various causes by placing a modest tax on any public financial transaction. Of course those favoring any tax always describe a new tax as modest however it may have a strong behavioral impact on trading and further restrain market returns. Difficult times produce attractive opportunities for PE investors that are nimble enough to adapt to the economic environment. The energy, health care and financial sectors immediately come to mind as areas where chaos and new technology is are creating some unique opportunities.

Investors have been surrounded by failure; failure of time-tested economic models, government and bank fiscal models and the failure of asset allocation models. Investors need to carefully examine their current asset allocations and prepare for a possible scenario that most advisors refuse to address. By actively reducing your risk, your portfolio should be well-positioned regardless of what lies ahead. Forewarned is a model for prudent action.

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