Coloring the Invisible Hand

By: Daniel W. Vasquez[i]

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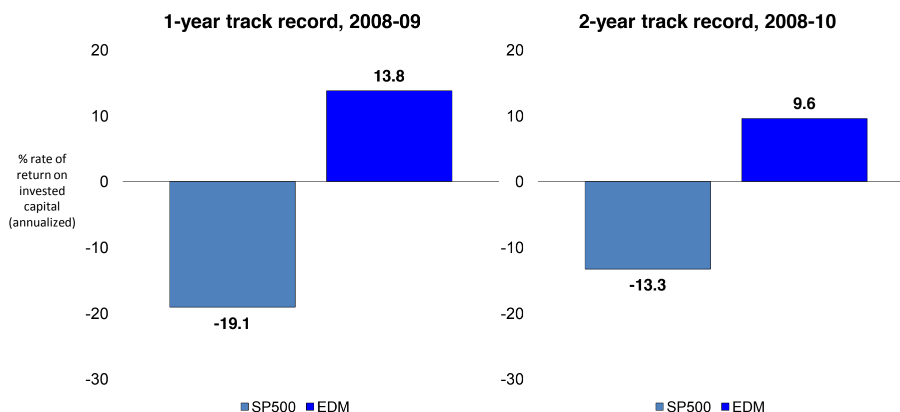
EDM Performance and Investment Strategy

EDM Investments generated an average +9.6% rate of return on invested capital for its investors since doors opened September 8, 2008 – one week before the financial crisis wreaked havoc on global capital markets and economies. We are proud of this fact. We not only survived but prospered in an environment where many outright failed. Darwin was right and misinterpreted: It is not the strong who survive, but the one most resilient to change and most adaptive to their environment. Venerable Wall Street banks and institutions folded once their accounting books were uncovered, exposing the excesses of leverage, debt, credit and, for a lack of a better word, greed.

EDM Investment Performance*



Note: *Inception date: September 8, 2010 and serves as a basis for performance comparison.
Source: Standard & Poors; EDM Investments.

While it is important to emphasize that past performance is not indicative of future results and given the above figure, EDM Investments certainly performed well for investors. In the darkest days of the financial crisis (2008-09), EDM Investments returned +13.8% to investors while the market, measured by the SP500 index, bled -19.1%. Two years later the market is still in negative territory[1], -13.3%, while EDM Investments nearly returned, on average, +10% to you.

We did make some bad bets over the past year, however. We gave in to speculative fervor when we bought a position in Goldman Sachs at 160 per share, from a high of 182, when the SEC complaint was made public this spring, only to see the price decline further to 129 weeks later. We also held a position in BP for almost two years only to see it lose nearly half its value several months after the Gulf oil spill. Who saw that one coming? Needless to say, we learned our lesson in giving in to animal spirits and to nature's unpredictable randomness. Despite these bad calls, we still outperformed the market by 233 basis points since 2008.

How we accomplished this feat is no secret. We did not use gimmicks. No leverage. No borrowed money. No credit. No speculation. We practiced a disciplined application of a constant theme that we've been hammering on since our first investor letter two years ago. This theme is easy to write, easy to state, and easy to apply in the short-run but very difficult to apply in a consistent way over the long-term.

When I was Harvard Business School researcher working under Professor Michael Porter more than a decade ago, I learned that strategy is all about choices. Strategy is making tradeoffs in competition, choosing what to do to and what not to do. Excluding certain activities that do not bode well for your unique position in the competitive landscape allows one to gain competitive advantage in any field, market, industry, or sport for that matter. Strategy is the creation of a unique and valuable position, involving a different set of activities from other competitors. Choosing what not to do is as important as choosing what to do. Our bottom-up, value-based investment strategy is guided by the following principles:

1. We focus on the estimated intrinsic value of a company, as represented by its projected future earnings, rather than attempt to divine markets trends. We look for inequalities in price and value.
2. We ensure that a sufficiently large margin of safety exists – the difference between a company's assessed intrinsic value per share and its current market price per share. We dig deep into company financials; evaluate competitive strategy ("how they're playing") and industry position. We also evaluate industry structure ("rules of the game"): concentration, fragmentation, market share, opportunities for consolidation (e.g., Mergers & Acquisition, IPOs, etc).
3. We apply independent judgment in valuing company shares of stocks, which may often imply a contrarian investment policy.
4. We limit transaction costs and ignore the distractions of constant price quotation via cable TV, the internet, iPhones and Blackberries by maintaining a steadfast holding of company stocks. There is a difference between market noise and real, material, value-changing information. We do not churn portfolios – excessive buying and selling, or day

[1] From a September 8, 2008 base.

trading, of stock shares. We only sell when it makes sense for you, the investor. We build long-term wealth, not short-term riches.

5. We practice a policy of portfolio concentration by committing relatively large sums of capital to market stunners. We reinvest all dividends. We buy 5 to 10, no more than 15, companies, not stocks. We own companies. We do not rent stocks. We identify companies with attractive dividend yields, steady and consistent dividend payout policies, and little-to-no debt on their books.
6. We maintain the appropriate temperament by balancing equanimity and patience with the ability to act decisively. We keep our head above the fray and always reevaluate portfolios and companies with a new set of eyes so as to maintain objectivity under changing company facts, delicate macroeconomic environment, evolving regulatory regimes, and volatile market conditions.
7. We stay abreast of world events, culture, philosophy, religion, the arts, and other human constructs that may affect values.

That said, EDM Investments will continue to apply this approach and chart a new strategic direction in evolving global markets (more on this later).

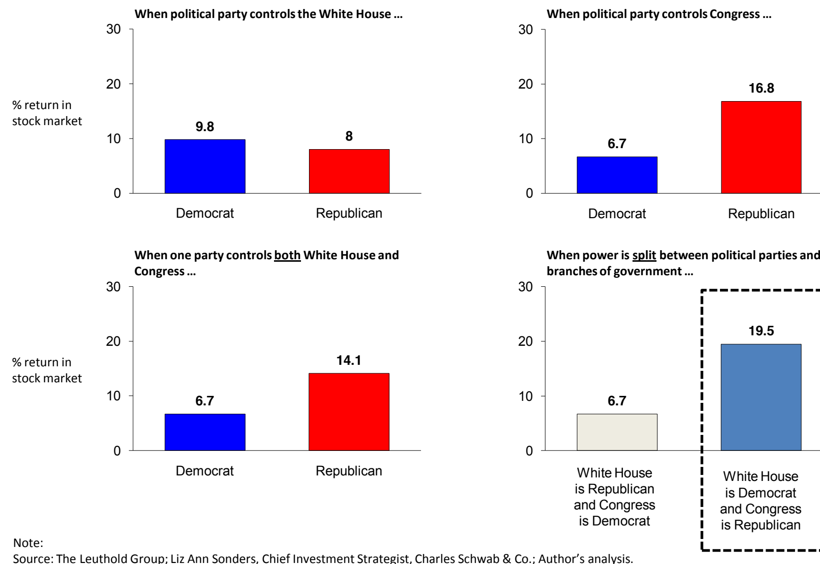
Mid-Term Elections and Market Performance

From our last investor letter, mid-term elections always present unique moments of tactical shifts for the United States. These shifts may be cultural, political, social (Remember Newt Gingrich's *Contract with America* in 1994?) as well as, and more importantly, shifts in the realm of economics and stock market performance. Typically after a president wins the election, the first two years are spent pushing through as much policy as possible.

Conversely, as presidents and their parties get anxious about holding on to power after mid-term elections, they begin to prime to the pump in the third year, fostering bull markets, prosperity and peace. Among the two branches of government (Executive and Legislative) charged with short-term economic diagnosis and prescription, these possible political alignments exist in Washington at any given time:

Stock Market Performance & Branches of Government

Rate of return (%) on stock market performance (Dow Jones Industrial Index) from 1949 to 2007 …



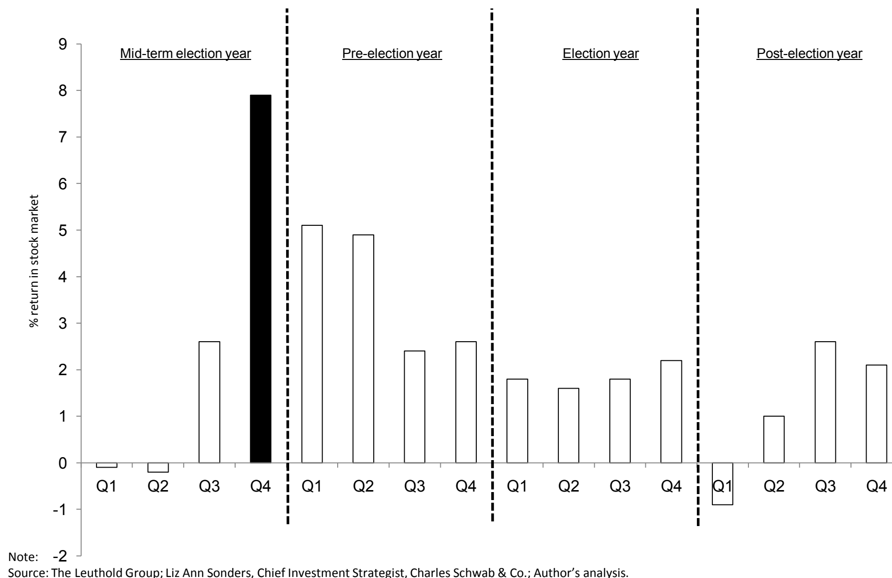
From the figure above, market performance under the six scenarios provides insightful results that run counter to conventional wisdom and political polemics. For example, analyzing historical performance data of the Dow Jones Industrial Average Index ("DJIA") from 1949 to 2007 reveals that:

- Under Democratic Presidents the stock market historically returned 9.8% versus 8% under Republican Presidents;
- Republican Congresses have yielded a 16.8% gain compared to 6.7% return when Democrats have controlled The Hill;
- When Republicans control both the White House and The Hill, gains have been 14.1%;
- When Democrats control both the White House and The Hill, gains have been 6.7%;
- When power is split, with a Republican President and a Democratic Congress, or a split Congress, gains have been 6.7%;
- When power is split, with a Democratic President and a Republican Congress, gains have been 19.5%;
- There has never been a Democratic President with a split Congress.

The best possible alignment for EDM investors (your political inclination notwithstanding), in a post November 2010-world would be with *Democratic President Obama still residing in the White House and Republicans ruling the Hill*. This scenario yields the best possible empirical result: Nearly 20% in annual stock market return since 1949.

Stock Market Performance & Political Elections

Rate of return (%) on stock market performance (Dow Jones Industrial Index) from 1929 to 2009 …



From the figure above, history has also shown that this November's mid-term election could very well prove to be a promising one for investors. Eighty years worth of market return data from 1929 to 2009 demonstrates that the fourth quarter of a mid-term election year is the best performing quarter in the stock market under any presidential cycle. So hang tight. With history as a guide, investors should be well served going into 2011. I wish the same can be said for the economy, however.

Despite strong headwinds, there are promising signs for the US economy as of late with recent short-term macroeconomic data showing:

- increases in durable goods orders
- private sector job creation (albeit not enough of them and at a snail's pace)
- declining trade deficits
- gains in productivity
- rising stock market

Long-term structural threats remain, however, with escalating public debt levels possibly comprising our national financial solvency and international credit rating. (See our previous investor letter about the role of public debt in investing.) The output and productivity of our national industrial portfolio is realigning itself into a new configuration with stresses and strains on new job creation in developing, or yet to mature, industries (e.g., alternative energy, clean technology, nano-technology, life sciences, and other bio-related fields). Banks and corporations are hoarding nearly $3 trillion in cash, waiting to be spent in hiring new workers, buying new equipment, investing in research and development, and in retraining the existing workforce.

Banks will not lend to small businesses, however – the main job creation engine of the country – nor will corporations hire new workers or buy new capital equipment (trucks, computers, buildings, etc.) until they receive some signal from Washington about tax rates, China trade policy and an overall economic competitiveness plan for the nation. Doing so would greatly reduce the public policy uncertainty needed for further domestic investment. To quote the CEO of global chemical conglomerate Dow Chemical, Andrew Leveris, at the most recent Clinton Global Initiative gathering in New York City: *"Nation by nation, we got rational certainty [about regulatory structure and governmental oversight] … This nation [United States] needs to catch up!"* Echoing this sentiment is CEO of Standard Chartered Bank, Peter Sands, also at the same Clinton Global Initiative meeting: *"Cash from banks and corporations is sitting on the sidelines until there is certainty about rules and regulations."*

While passing health care and financial regulatory reform was a step in the right direction, protectionist rhetoric coming from Congress could prove counter-productive. Congress – in its pressing need to show short-term results in addressing the 9.6% national unemployment rate before November mid-term elections – threatens to press China with trade sanctions resulting from alleged Chinese currency manipulation. (Keeping the value of its currency artificially low makes Chinese exports that much cheaper in global markets.) The Chinese retaliated last Friday (9/24/2010) by imposing sanctions on American chicken imports (106% of import value).

Should the United States Congress deepen this trade war of words, it could have deleterious effects for interest rates and inflation in the US as the Chinese are major holders of US debt. The Chinese could easily dump their US Treasury holdings onto global capital markets, thereby inducing higher interest rates to compensate for holding US debt, thus reflecting a higher cost of capital for the increased risk. And let us not forget that it is largely foreign holders of US debt that has by and large financed our American standard of living over the past three decades. A rise in interest rates will increase inflation to higher levels for the American people. Doing so will eat away at the purchasing power of the dollar. Market forces are not patriotic.

Economic growth cannot come from the public sector alone – that is the private sector's main charge. But the private sector needs some real, salient, material signals from Washington as to any new rules, new regulations, and a new competitive landscape in global markets. Only then will private capital unlock its value creation capacity to hire new workers, buy new equipment, invest in research and development, and retrain the American worker to compete.

Together, government and business need to hammer out a new compromise, a new competitive environment, and a new set of incentives to compete globally. This will lead to a restoration of confidence. Washington can help restore confidence in the business sector by minimizing public policy uncertainty and unveiling its plan for national competitiveness. The nation needs an offensive playbook from which corporate America can run its formations, call its plays, and compete. And so does the referee.

The "New Normal" and Investment Returns

Depressed, if not muted, returns have been the norm in the market these last several years. Investors accustomed to exorbitant returns have had to temper and manage their expectations accordingly. A new thesis, the "New Normal," surfaced in the economic and financial vernacular. The "New Normal" thesis states that investors should expect slow economic growth, high unemployment, and accelerating inflation. The New Normal will be an inherent part of our economy for years to come with economic growth of 1-2%, unemployment of 7-8%, and inflation kicking in over the next three to five years.

The New Normal replaces the previous paradigm, which many in the investment industry consider a "Child of the Bull Market" that had lasted for more than three decades. Under that paradigm, investors could rely on historically generous rates of return, and whenever returns lagged they would reliably revert to the mean. Barton Biggs, considered the poet laureate of the investment industry, encapsulated this line of thinking when he said that markets were good "because whenever they and the economy have gone down, they've gone back up to higher levels." Do not expect this anytime soon.

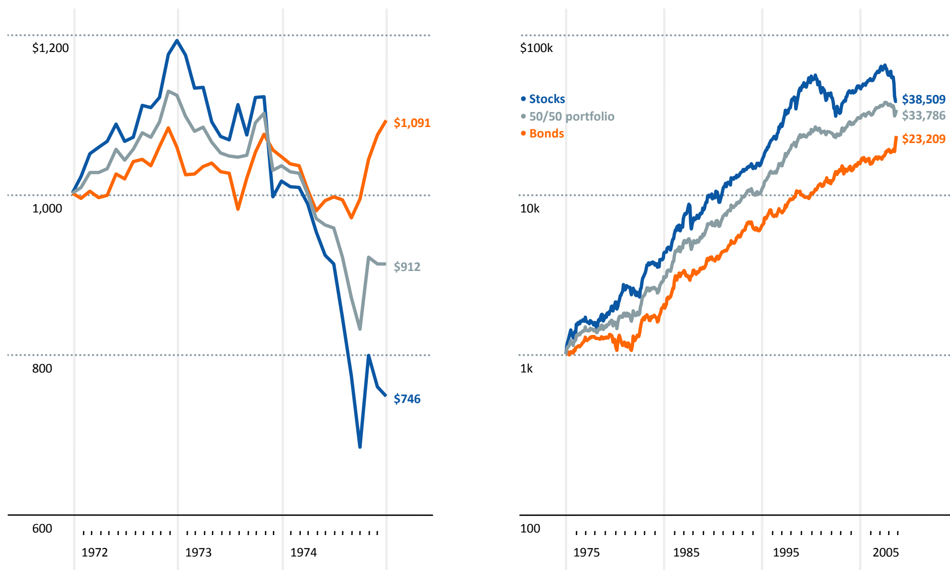
In a world of de-leveraging, de-globalization, and an all around tightening of the belt, markets will not bounce back to newer, higher levels in the short-to-medium term. Growth will be stunted and subdued, and this will have a big impact on corporate profits that could last years. Unless, of course, one is investing in ultra-quality, blue-chip companies which consistently pay healthy dividends and have very little, if any, debt on their books. Investments in growth company opportunities in Africa, Asia, and Latin America will be the areas for solid, consistent investment portfolio performance. Indeed, it is once again fashionable to invest in production, in companies that make and produce things which society needs in a cost effective manner. No Enron-accounting gimmicks. No leverage. No turbo-boosting returns. Generating sales, profits, and investment returns is, once again, done the old fashioned way: by earning it!

It is often too easy to get lost in the weeds. This is true for investments also. Despite the short-term prognostication virtue of the New Normal thesis, it is equally important to not lose sight of the broader brush strokes of financial history. Today's market climate is very similar to that of the 1970s and early 80s in financial markets. Stagflation (high unemployment and high inflation) was very much a deep threat, interest rates were readying to explode, rising commodity prices threatened overall business competitiveness, and the stock market appeared sluggish.

In the figure below, from 1972 to 1975, many nervous and fearful investors pulled their money out of stock market as prices were declining, while company intrinsic values held their line. An investor who put $1,000 to work in the stock market in 1972 would have seen their investment drop to $746 by 1975 (left panel on figure). However, investors who did not pull their money out of the markets benefitted from a three-decade gain unparalleled in history, from 1975 to

2005, and their $1,000 investment would have turned into $38,509 in 2005 (right panel on figure). The relevant question here: Can you stay on track?

Can You Stay on Track?



<u>Economic and Market Outlook for 2011</u>

Where we see opportunities for the remainder of 2010 and early 2011 are in continued stakes in ultra-high quality, blue chip companies with a global footprint, especially in emerging markets. These companies will be rich in cash, holding less than 10% of debt on their books and paying a consistent, healthy, growing dividend, while meeting the expansion needs of 1.2 billion new members of the global middle class.

We also see opportunities in municipal bonds that are not tied to state tax revenues (i.e., school district bonds) because so many states are running exorbitantly high deficits and cannot meet the budgetary needs required for state services. High quality utility, water districts, transportation systems and other infrastructure General Obligation and Revenue bonds stemming from local tax receipts, as opposed to state revenues, are best positioned in this environment.

The breadth and speed with which the 1.2 billion members of global middle class is entering the world economic fold also make it difficult to ignore the role of commodities in any investment program over the next 3 to 7 years. Simply put, commodities are the necessary raw materials used in economic growth. They meet middle class needs, and provide the raw input foundation with which development can occur (cement, steel, rubber, copper wires, etc.). Investing in commodities also acts as a buffer against inflation as well as a hedge against protectionist fears and geopolitical risks.

During the early stage of a bull market (like now), the majority of investable assets should be in the following asset classes: equity (stocks), fixed income (preferably tax-free municipal bonds), commodities (especially gold), real estate, and cash.

The relative weightings of each asset class will coincide with investment policy statements and long-term plans of individual and institutional investors. This is a prudent overall asset allocation strategy for these trying times.

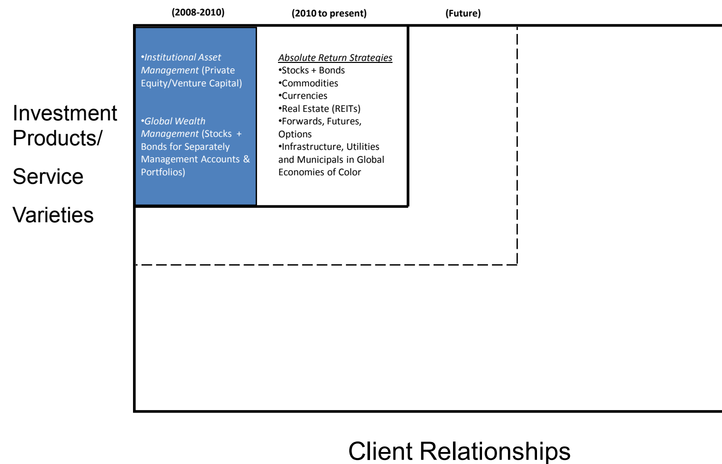
New World Markets, New Directions and Absolute Return Strategy

Begun two years ago as a boutique institutional asset management (private equity and venture capital) and global wealth management shop, serving the emerging domestic market in the United States; EDM Investments will evolve and move into a new investment direction, deploying an absolute return strategy, specializing in both the emerging domestic market and global economies of color. Doing so will give us greater flexibility to seek out investment opportunities globally in rising new world markets in Africa, Asia, and Latin America, while minimizing risk and volatility of returns domestically.

Absolute return investing is a resourceful strategy that can supplement traditional investments such as stocks and bonds. While investors justifiably look to stocks and bonds to build wealth over the long-term, in the short-term traditional strategies typically expose investors to significant volatility and sustained periods of negative performance. Both of these risks interfere with the goal of accumulating wealth and increasing purchasing power. Absolute return strategies pursue more consistent results in both the short-term and long-term. An absolute return strategy seeks to earn a positive total return over a full market cycle with less volatility than traditional funds and largely independent of market conditions. An absolute return strategy can outperform broad markets during periods of flat or negative market performance, also known as the "New Normal."

EDM Investments will chart this new strategic course by forming new alliances and offering more investment options to its investors through Chicago-based BrokersXpress in order to broaden EDM Investment platform options in commodities and futures, supplementing our traditional stock and bond offerings. In addition to our current status a licensed Registered Investment Advisor ("RIA") with our regulators, FINRA and the State of California, EDM Investments will also register with the National Futures Association as a Commodity Trading Advisor ("CTA"), providing advice and selecting futures contracts for its clients.

EDM Investments Growing Strategically



EDM Investments will maintain our bottom-up, value-based investment approach for our asset and wealth management business. However, we will begin to augment our value-based investment approach through absolute return investing by increasing our exposure to real assets like real estate, foreign exchange currencies, and commodities (cotton, grains, wheat, sugar, rice, platinum, palladium, silver, and gold, among others). An absolute return strategy can pursue the most attractive investments anywhere in the world; it can adapt to evolving opportunities; and it can utilize forwards, futures, and option contracts to reduce uncertainty.

As an absolute return money manager, asset allocation and diversification will remain important and be governed by the risk-reward profile of our clients. It is our sole priority in fulfilling our fiduciary duty to act, first and foremost, in our client's best interest.

World equity distribution from global economies of color increased from 22% to 25% in the past year. By 2050, world capitalization from global economies of color will account for 75%. They also hold substantially less debt than the advanced world, and are therefore more solvent and well-positioned for rewarding long-term investment opportunities. Ultra high-quality, blue chip investments from the advanced world, combined with growing new world markets in global economies of color still present the best opportunities for economic growth, development, earnings, capitalization, investing in profitable companies, and forwarding human progress.

We are, indeed, coloring Adam Smith's invisible hand.

In the next EDM investor letter:

- **On the Importance of Being Earnest**
- **Investment performance in Global Economies of Color**

For more information, contact EDM Investments at (510) 459-1264 or www.edmcapitalpartners.com.

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