The End of the Beginning

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In this investment newsletter:

- **Market overview**
- **Economics is not finance**
- **Speculation is not investment**
- **The road from here**
- **Asset allocation and portfolios**
- **Companies for the long-term**
- **Sorry economic neo-cons: you were wrong – for now?**

Market overview

The last two months have been one of the most tumultuous eras in financial history. Period. I watched last week – and for some reason I suspect I was not alone – with no little awe and plenty of shock as the stock market all but disappeared into, arguably, one of the greatest sinkholes in investment history.

- The Dow Jones Industrials (DJIA) lost 18% over five trading sessions that swelled their loss for the past 12 months to 40%.
- The S&P 500 also was off 18% for the week, 43% for the 12 month period.
- Not to be left behind, NASDAQ lost 15% for the week and 42% since October 2007.
- The October totals so far are as follows: DJIA -22.1%, S&P 500 -22.8%, NASDAQ -21.1%.
- The stock market has crashed in unprecedented fashion. Rather than crack on a single day in a high volume debacle, the stock market has collapsed in a bizarrely ordered two week waterfall of down days.
- The VIX – the market's fear gauge –reached an all time high, 76.

This financial crisis is as deep as the one that afflicted our financial system in the 1930s, when thousands of banks failed and millions of Americans lost their life savings.

But do not throw in the towel just yet . . . this novella has a happy ending.

Economics is not finance

It is important to divorce economics from finance, investment from speculation. While it is true that money is the lifeblood of any economy, it is also true that the organs (business and industry) of the current U.S. economy are still functioning and functioning well – albeit with tainted blood. The risks lie with misdiagnoses and delays by the government, and lack of blood supply by the banks. Until banks start lending again and credit starts flowing, American business and consumers will be waiting in line at the local Red Cross.

While there are similarities with the 1920s and 30s, there also remain plenty inherent differences worth highlighting:

- In the 1920s, stocks lost more than 90% of their value – not so today.
- Depositor and investor safeguard protections such as FDIC and SIPC did not exist in the 1920s and 30s. Both insurance programs were created as a result of that crash and have served us well since. For the average investor and depositor today, their money is safe.
- The real economy (industrial output) during the Great Depression slowed more than 40% for the entire U.S. economy —not so today. While the engine today is in need of a tune-up, some of its parts will need major repairing.
- During the depression, more than 25% of the American workforce was out of work—not so today. We may see 8% unemployment next year.
- Globalization can be a double-edged sword: it can help numb the pain or intensify it, as it creates interlocking fragility among and between countries while giving the appearance of stability.

Economic and financial history teaches us that the average U.S. recession since the late 1940s has lasted 10 months, and stocks typically reach their low point about three months before the recession ends. So, if the U.S. entered a recession on July 1, as many economists now suggest, and the recession was to last until April 2009, a typical bottom for stocks would occur sometime in the next few months.

Speculation is not investment

The run up to this two-week orderly crash was largely driven by speculators. We've had this craze of speculation in recent investment history through hedge funds, short sellers, derivative instruments, and financial engineers creating (and subsequently trading) property rights out of "thin air" from nebulous – more like amorphous and porous – financial statements, and – quite frankly – it's crowded out intelligent investing.

For example, in 2000 and at last year's high, the value of American business stood at $15 trillion, as measured by the S&P 500. After Friday close, the value of American business stood at $9 trillion.

Does anybody in their right mind really believe that the value of American business dropped by $6 trillion in such a short period? American business has grown every year in little ways and big, because that capital produces real earnings though gains in productivity.

In this speculative market we've forgotten the fact that investment fundamentals prevail. The dividend yield on the S&P 500 has gone from 1% to 3%, while the market is down 40%. The book value of the S&P 500 has almost doubled, from $2.3 trillion to $4.2 trillion.

Instead of having a market price seven times book value, the market is twice book value. The market relative to the book value and dividends it pays is far cheaper than it's been in a long time.

In short, we've had too much speculation, not enough long-term investment; too much trading and churning of company stocks and options, not enough buy-and-hold in good, quality companies.

This is beyond semantics.

What we've witnessed is the madness of crowds. We've lost our way. During this crazy era we've let the speculators run the train. We've let the nuts run the insane asylum.

We'll have to shake out a lot of toxicity from the global financial system – call it what you will: de-coupling, de-leveraging, de-tox, re-alignment, re-incentivizing, re-hab, cleansing, limpieza, Native American sweat, financial meditation, yoga for yields. Whatever.

The road from here

What does an investor or trader do now?

For the latter, these are golden days as hard as that may be to believe. Traders crave volatility. The past few weeks have presented once-in-a-blue-moon opportunities for day traders and swing traders. For those that have guessed more right than wrong, the profits have been off the charts.

For investors, however, it's a completely different story. The challenges of the current market are daunting. Fortunately, even with the carnage that has now taken place, they are not too formidable to overcome.

Remember how the Warren Buffets of the world grew their fortunes. They buy when everyone else is selling. The time to sell is not when the markets are down and fear is rampant. Rather, it is precisely at these times when the outlook is the bleakest that equities offer the most attractive returns.

Now is not the time to panic.

From the previous investor newsletter, it is worth remembering that after a significant market drop: "On average the DJIA was: 10.4% higher six months after the decline; 13.8% higher one year after; 27% higher two years after; and 45.6% higher five years after."

It is foolish to try and pick the precise bottom of either the stock or financial markets in today's environment. In the short-term, anything can (and will) happen, since emotion dominates economics. Yet at these levels it is virtually certain that stocks will be a rewarding investment for long-term investors.

Just as happened after the Great Depression and the Crash of 1987, there will be a point a few years down the road when all investors will look back and be shocked at the low prices at which stocks were bought in late 2008.

Asset allocation and portfolios

During severe bear markets (like now), the majority of investable assets should be in: cash, fixed income (preferably tax-free municipal bonds), gold, art, commodities and inflation-indexed securities.

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 while investors should snoop around for opportunities.

Once the culmination and bottoming of the bear market ensues and the early stage of a bull market emerges, new strategic asset classes and tactical weightings for investor portfolios are in order.

Economic and financial history has rewarded investors who had the fortitude to step forward in this environment.

Companies for the long-term

That said, for EDM clients and investment partners I like companies that deliver cash to their shareholders (investors, not speculators) in the form of dividends, that also maintain prudent, disciplined balance sheets with very little debt or leverage. Cash is king.

These companies tend to generate impressive cash flows, earnings growth, generally operate at attractive profit margins and could offer both comfort and upside during turbulent markets.

Normally these companies have excelled at their business strategy and have sustained competitive market position in their industry. In short, these companies are tried and true over time, and show you the money. They are boring but with a lot of substance.

- Clients and investors may want to consider long-term investments in the following U.S. companies when share prices are attractive relative to intrinsic value: Altria (MO), Coca Cola (KO), DuPont (DD), Home Depot (HD) and Pfizer (PFE).
- Clients and investors may want to consider long-term investments in the following international companies when share prices are attractive relative to intrinsic value: AstraZeneca (AZN), BP (BP), Nokia (NOK), Toyota Motors (TM), Total SA (TOT), and Vodafone (VOD).

Sorry economic neo-cons: you were wrong – for now?

The market for ideas – like the market for company shares – always overshoots. Ideas become fashionable and get pushed to their logical conclusion and beyond, as their backers succumb to "irrational exuberance" or "hubris" or worse, "epistemic arrogance."

Then comes the crash.

What we are experiencing now is the bust that has followed a 30-year bull-run in neo-conservative economic ideas that were popularized with the Reagan-Thatcher revolution of 1979-80.

The current financial crises can be traced to three central ideas of the Reagan-Thatcher era: the promotion of home ownership, financial deregulation and a fervent faith in the self-regulating, self-correcting mechanism of free markets.

Each of these ideas did sterling service for three decades, increasing prosperity and freedom on average. But pushed too far – and combined – they have created a disaster.

The ideological roots and home base of the neo-conservative era lay at London School of Economics and The University of Chicago with economists F.A. Hayek and Milton Friedman and philosopher Leo Strauss, and evolved as a reaction to the excesses of the Keynesian consensus so prominent, but necessary, after The Great Depression.

Now that the intellectual cycle has swung decisively against the rightwing ideas of the Reagan-Thatcher era, it is bound to overshoot in the other direction as well.

The joys of government regulation will eventually pall and free market fundamentalism will find a crack opening to reign in on the third-way, modern day variant of the Keynesian consensus – "Socialist Free Markets."

In several years' time, nostalgia will set in for the go-go years on Wall Street and for the bracing "moral certainties" of free market neo-conservatism.

New global financial centers may rest in Dubai, Sao Paulo or Johannesburg, instead of Manhattan, London or Tokyo.

Audacious intellectual investors should now be sniffing around and hold some dry powder cash. Ahead in the distant horizon several thousand miles away where the modern Keynesian revival may run its course, deregulation and free markets will once again be a "buy" at bargain prices. Until then, caveat emptor.

To quote Winston Churchill: "Now this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning."

Next investor letter:

- **Post-presidential election investment strategy**
- **Credit crisis and Christmas**
- **Profit is opinion, cash is fact**
- **Frontier markets or economies of color**

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