The Patient and Disciplined Investor…

Ruminations on long-term wealth building

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November-December 2011

Volume 2, Issue 10

"Prosperity ends in a crisis. The error of optimism dies in the crisis, but in dying it gives birth to an error of pessimism. This new error is born not an infant, but a giant." - Arthur Pigou

The Volatility Continues

As I write today, stock market volatility continues mainly due to European debt. One of my biggest challenges is helping clients deal with the emotions that are triggered during these market declines. It's tough, but therein can be the opportunity. In my experience, successful investors have the skill set to hear the contrarian voice inside their heads, keep rather unpleasant news in perspective, or see things from a larger perspective and keep their longer-term goals in mind. Oh hell, maybe they just plain stick their heads in the sand. Regardless, it helps when you bring someone like me into your orbit to keep you focused because patient, disciplined investors have generally been well-rewarded.

I'm acutely aware that pessimism is running deep in many circles. And I agree that, should there be a disorderly default of European debt, we could see even worse volatility in financial markets. But I also understand that if you would have given in to fear in the past when making long-term investment decisions, you most likely would have regretted it. For money not needed in the next 8-10 years, consideration should be given to investing in a broadly diversified equity portfolio. If your time frame is less than that, then other places might be more appropriate.[1]

Investors (and many financial professionals) tend to focus on current events – happily delivered by the media – in the false belief that investment losses must somehow always be avoided.[2] Remember that some amount of volatility risk is necessary if you seek to minimize the inflation or purchasing power risk in a world of increasing life expectancies. Focusing on today's events can blind you to the larger, broader trends that are far more important for long-term investors. If you're a speculator, however, instead of an investor – no subtle distinction - then current events matter. But if you're an investor with a long-term focus, then current events should be of little concern to you. Instead, I encourage you to focus on the longer-term trends when deciding where and to whom you should deploy your capital for investment. In no particular order, here are the four broader trends that I believe investors should be considering:

Emerging Market Demographics – ("Positive"). I continue to be very optimistic on emerging demographic trends in the world economy. Three billion people are moving from poverty and into the middle classes. For a broader discussion, please see my September-October 2011 edition of The Patient and Disciplined Investor.[3]

U.S. Energy Production and Manufacturing - The "Shale Revolution" ("Positive"). I have been quietly following the developing story of U.S. energy production – a situation that could turn the U.S. back into an exporter of energy and net gainer of

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[1] This point goes to the heart of an asset allocation strategy. In general, if you need the funds within two years, cash instruments are appropriate. If it's 3-7 years, bonds may be a better option. Anything longer than that generally points to equity-oriented investments. Consider, too, that most people do not need the bulk of their retirement savings all at once or in the next seven years – especially if you are in good health.

[2] For a mostly humorous, though ridiculous, recent example of media fear-pandering, see http://ca.news.yahoo.com/u-stocks-massive-melt-fans-investor-fears-201253607.html. Stocks "melt up" for "no apparent reason" and "scare" investors. That used to be called a "rally".

[3] http://farmersagent.com/Assets/Agents/tkirsch/Docs/October%202011-tkirsch.pdf

manufacturing jobs.[4] At the risk of being politically incorrect, I've been getting on board with this success story. Unfortunately, I am no expert on the hazards of hydraulic fracturing for natural gas and oil, but this has the environmentalists concerned. My periodic cynicism tells me that politics rather than science are behind the environmental objections.[5]

The jobs and resulting "spin off" jobs that could be created due to the Shale Revolution look to be enormous.[6] This could significantly turn geopolitics in our favor[7], strengthen the dollar, and bring the U.S. current account back into balance. The resulting tax revenues could help solve our looming entitlement mess. In other words, don't count America out quite yet. Stay tuned.

Stock Prices Wax and Wane Around a Rising Trend Line of Earnings – ("Positive"). This idea cannot be said often enough – current and anticipated corporate earnings and dividends drive stock prices. And corporate earnings continue to be strong.[8] If you landed here from outer space, however, you might think stock prices were a function of shrieking media headlines and irrational emotions. They aren't – at least not over time. Stock prices are a function of how much money companies are earning, today and in the future, and how much investors can expect in the form of dividends. Now admittedly, the relationship between stock prices to earnings and dividends can be lower or higher than normal – and for long periods of time - but stock prices have had this persistent, relentless way of reverting to the mean or average over time.[9] Humans are evolving faster than ever and sharing ideas at an increasing rate – all of which is being moved along at warp speed by the internet.[10] Bring another three billion people on board into the world economy to share ideas, and you start to get the sense that technology could easily solve today's most vexing problems.

Government Debt and Demographic Trends – ("Negative"). You've heard for years that the Baby Boomers are coming…well, they're here. Government debt in the developed world, political gridlock, and aging populations will present difficult challenges to developed-world economies. Americans will be faced with extraordinarily complex questions with no easy answers that will challenge our ethical mores. For example, there is a finite, though increasing, amount we can spend on health care. From a cynical point of view, how much should our government borrow to pay for expensive medical procedures for people in poor health over the age of 85? Would those resources be better deployed towards our younger citizens who have challenges of their own to becoming productive in society? No easy answers there. How do we honor the promises – or not - made under Social Security, Medicare, and Medicaid without causing everyone to throw tea in the harbor? Though still far-fetched, Greece-like riots could be in our future. Our leaders will either have to cut benefits, raise taxes, or inflate our way out of the problem – but which groups should win and which groups should lose? Perhaps we can grow our way partly out of the problem – I haven't ruled that out given the noted positive trends above. But considering our demographic challenges, enormous size of government, and political gridlock, this will be difficult.

Books to Consider for Your 2012 Reading List

Below I've summarized the books I read in 2011 related to investing and economics. Should you choose to read any of them, I would enjoy discussing the ideas with you. In addition, books on the financial crisis that I read this year were "Crash of the Titans" (The demise of Merrill Lynch), "A Colossal Failure of Common Sense" (The demise of Lehman Brothers"), and the "The Big Short" (how a few small, independent individuals and groups of people

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4 http://www.telegraph.co.uk/finance/comment/ambroseevans_pritchard/8844646/World-power-swings-back-to-America.html

5 For example, see the Wall Street Journal, November 11, 2011, "U.S. Puts Oil Pipeline on Hold"

6 See Wall Street Journal June 13, 2011, editorial by Robert Bryce

7 www.foreignpolicy.com/articles/2011/08/15/the_americas_not_the_middle_east_will_be_the_world_capital_of_energy

8 According to Professor Jeremy Siegel's November 5th newsletter, 2011 S&P 500 earnings will top the record $91.47 earned prior to the 2008 downturn.

9 For an excellent discussion on the history of stock prices since 1801, see Stocks for the Long Run, Jeremy Siegel.

10 For an outstanding perspective on human progress sharing ideas, see The Rational Optimist by Matt Ridley. A summary of the book is below in this newsletter.

shorted the housing market before it went bust). The Big Short was my favorite of these three – insightful writing and hysterical in places.

"The Econoclasts" by Brian Domitrovic. This is a must read for every investor and economics student – perhaps every American. If you want to understand what "supply-side economics" really means – not how the media spins it - and how monetary policy (Federal Reserve) and fiscal policy (tax rates) affect the economy, then read this book. The author goes back to 1913 when both the Federal Reserve was created and the 16th Constitutional amendment was passed authorizing the federal government to collect an income tax. The story continues through the end of World War II when the dollar was established as the world's dominant currency at Bretton Woods. We see Kennedy's tax cuts in the early 1960s that were supply side in nature. Then the late 1960s and 1970s saw some disastrous economic policy that created stagflation. The result was a weakening dollar, high tax rates, and inflation. By this time, the supply side movement was under way with economists Robert Mundell and Art Laffer, along with the Wall Street Journal's editorial page editor, Robert Bartley. Mundell had been advocating for years that monetary policy should only focus on price stability[11] and that fiscal policy should focus on domestic growth. High inflation and taxes of the 1970s were killing the incentives to work and invest – and were instead promoting demand and consumption. Decreasing supply and increased demand led to high inflation. Commodities and collectibles increased in value while financial assets suffered. Eventually, Reagan embraced the supply-side ideas, and the U.S. turned the corner from stagflation to staggering growth.

"The Rational Optimist" by Matt Ridley. This, too, is probably a must-read for every investor. Though not necessarily related to economics, the author examines how humans are progressing economically through the sharing or "mating" of ideas and what he calls the "collective brain". Economic evolution is increasing at an increasing rate due to this sharing of ideas – which rate will accelerate in the coming years. A common flaw of man in examining the problems of his time is assuming that future problems will be solved with today's technology. Not true, argues the author. He takes us on a journey of how we've solved seemingly impossible problems as technology advanced.

Specialization of labor is in everyone's interest.[12] Let's assume I can make fishing nets better than I can fish. Conversely, you can fish better than making fishing nets. If so, it makes no sense for me to spend my time making fishing nets and also fishing. Rather, I should focus on making nets, sell my fishing nets, and simply buy fish from you. This raises everyone's standards of living. The author says to expect more niche products and services in the future, more specialization of labor, and therefore even higher living standards.

The author provides a very rich history of how humans have progressed from 100,000 years ago to the present. Stick with him during the first sixty to eighty pages as he sets it up from a historical point. The book is well worth the read. You will also come away with a much better understanding of energy issues – there were particularly interesting points in the book on the evolution of energy from slaves to wood to fossil fuels. With an additional three billion people in emerging markets beginning to contribute to the "collective brain", things should get interesting.

"Exhorbitant Privilege" by Barry Eichengreen – This was a very good book on the evolution of our currency and the current status of the U.S. dollar as the world's reserve currency. My only complaint was the author's rather shallow and unexamined opinion that corporate greed caused the 2008 financial crisis. It was certainly more complex than this. Regardless, it's well worth the read if you want to understand currencies better. I understand that the dollar doesn't have the strength and prestige it once did – causing some to fear a dollar collapse. But this book will help you understand that there simply aren't any good alternatives out there to challenge the dollar – at least for now.

"It's Different This Time" by by Carmen M. Reinhart and Kenneth S. Rogoff – I saw this book quoted in so many articles and books that I finally

[11] The Fed officially has had a dual mandate of "price stability and maximum employment." http://www.federalreserve.gov/faqs/money_12848.htm

[12] Sure, this is not necessarily a new idea and is basic Adam Smith 101 economics – i.e., The Wealth of Nations. But Adam Smith, who wrote in the 1700s, could not have envisioned the trajectory of economic evolution on which we are now.

had to pick it up. It's scholarly all right and is certainly not for your ordinary arm-chair economist. It does, however, give the reader very good insight and distinctions on exactly what constitutes a government debt default, how and when they're likely to happen, and how they're related to other variables in the economy. One mild criticism of the book would be there was too much…we're going to tell you this, we're now telling you this, and we told you what we told you. The book could have been written in 1/3 less pages.

"Crisis Economics" by Nouriel Roubini. I'm firmly in the optimist camp when it comes to investing, and that's why I had to pick up the latest book by the notorious bearish Noriel Roubini. It's true, he's not exactly a bright and sunny optimist. But for a rigorous analysis of the issues facing politicians and regulators today – along with Mr. Roubini's ideas to create a better economic environment - it was a very interesting read. Try not to get sick when you read about the extent of all the bailout money handed out by our government – I knew it was a lot, but it was really A LOT.

"Inflated – How Money and Debt Built the American Dream" by R. Christopher Whalen. This one took some fortitude to get through it, but the author brings together many significant historical events that he believes were the precursors to the significant problems affecting us today. Like so much financial history, the recent financial crisis was nothing new. The actors and circumstances are different, but the stories of financial crises are always strikingly similar.

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