The Death of Buy and Hold

If there was any optimism heading into 2009 it has all since vanished as economic and financial market news has exponentially gotten gloomier with each passing week. After the worst January on record, the markets posted their worst February since the Great Depression. The DJIA, S&P 500 and NASDAQ Composite finished the month down 11.72%, 10.65% and 6.68% respectively, bringing the year to date returns to -19.52%, -18.18% and -12.63%. With no end in sight, market soothsayers are predicting all kinds of fantastically depressing numbers for the Dow and S&P, in the ranges of 5,000 and 500, respectively. More disconcerting still are the hard facts of the current crisis, most prominently the revised fourth quarter GDP number. Initially reported at -3.8%, the Department of Commerce reported that the economy really contracted at an annualized rate of 6.2%. With a discrepancy that large, it begs the question: Are the estimates really that difficult to make or are we just being lied to? It's not an unreasonable question given the track record of missed estimates and outright manipulation of statistics like the CPI (Consumer Price Index), money supply and unemployment. What it has added up to is a rude awakening for the American taxpayer who has been lead to believe that things are still "all right".

It was housing that saved us from that last recession and it was not by coincidence. With tech stocks plummeting and scandals at Enron and WorldCom, the focus of the economy moved from technology to financial services at the turn of the millennium. While the NASDAQ composite has been unable to climb back to the lofty levels of 1999, the massive losses sustained by investors in equities was offset by rising real estate prices. A combination of cheap credit, mortgage (and generally all assets) securitization allowed for new home owners to purchase houses they could never have afforded. Equity lines of credit allowed consumers to fuel markets for another seven years before the recent crisis took hold in August 2007. While the story of sub-prime mortgages and the real estate bubble is well known by now, the role of our government in promoting a consumer spending spree has gotten little coverage. With the exception of the scrutiny of Fannie Mae and Freddie Mac, the media has rarely focused on the upward growth bias that our government promotes through the manipulation of government statistics. It makes for more drama to have bank CEO's flogged in public. Perhaps there should be a reversal of roles in the congressional Q&A sessions, where the tables are turned and our elected officials explain why they failed to see the current crisis for what it is. This type of self-delusion is conducive to the boom-bust economic cycles we see in the U.S. When things are good, we consistently underestimate leading indicators of risk, leading to a more dramatic bust when the party stops. Then there is a good deal of head scratching when the numbers show us just how bad it is.

This type of thinking also penetrates the private sector where risk models aren't built to survive a "Black Swan" event. The massive understatement of risk, endorsed by rating agencies with major conflicts of interest, allowed companies like Citigroup and AIG to falsely believe their risk was limited and their bets were hedged. The use of off balance sheet entities and creative accounting has led many of the banks currently in crisis to believe they could or still can make it without a bailout and/or government intervention. Dick Fuld, former CEO of Lehman Brothers, and Jimmy Cayne, former CEO of Bear Stearns, both miscalculated when they thought their firms could tough it out and then make a deal on more favorable terms. The naivety that characterized that collapse (up until the last days, did anyone, especially Dick Fuld, really believe that Lehman would go down?) is present today in the form of AIG, Citi and Bank of America. All of these companies have been slowly biding their time and hoping things get better. Unfortunately, for AIG, things got significantly worse, as the world's largest insurer, posted a $61.7 billion quarterly loss, the largest in U.S. corporate history. Over $20 billion of the loss came from exposure to credit default swaps, a derivative instrument the government has declined to regulate. All of these companies know they are too big too fail, and if they wait long enough, the government will help them on their terms, whether Ben Bernanke likes it or not.

It is precisely this kind of naivety that is the defining characteristic of our government, who would rather sugarcoat poor economic indicators for fear of angering the American taxpayer. Two of the most well-known indicators that are manipulated are the CPI, which is a barometer of inflation and the unemployment figures monitored by the Bureau of Labor Statistics. In the early 90's, Fed Chairman, Alan Greenspan, and the Boskin Commission were attempting to reduce government spending, most notably social security outlays, but could find no politically feasible way to cut benefits. Yearly increases in social security benefits, along with government wages and many government agency budgets, are tied to the CPI. The findings of the Boskin Commission and Greenspan concluded that inflation was overstated by as much as 1.5% and recommended that Congress revise the calculation. The subsequent changes passed in the late 90's have misrepresented inflation by using geometric weighting, hedonic quality adjustments, not to mention the exclusion of food and energy in core inflation reading. If it all sounds too complicated, it is. The use of geometric weighting attempts to read the extent to which consumers switch from one good to another, for example from steak to hamburger. As demand for cheaper goods goes up, their weighting within the index also goes up, in effect lowering the index itself. The use of hedonic quality adjustments is used to determine the price of new goods that are replacing items consumers are no longer buying, such as an old television that is replaced by a plasma flat screen. There is clearly no ideal method to calculate inflation, but all of these adjustments don't relate to the actual dollars being spent by consumers. The exclusion of food and energy prices, while limiting volatility, also understates the effects of rising prices on Americans. The impact of large expenditures like higher education and healthcare, which are both growing at well above core inflation, have scant representation in the index. Rather than address these issues head on, the choice has been to hide the reality of the problem.

In the case of some government statistics, such as M3, the broadest measure of U.S. money supply, we have simply stopped tracking it. Given the expansion of massive government spending in the past year, the rate of growth would be staggering and would frighten not only the American taxpayer, but foreign bond holders who would ask for a higher yield on the U.S. Treasuries they hold. The value of the dollar would also be questioned, especially by the oil producers in the Middle East that have pegged their economies to it. In addition, since the start of the Iraq War, no federal budget has shown the impact of a war that may cost several trillion dollars before it is over. If Americans knew the extent to which our nation is indebted, we believe the savings rate of American households would have been dramatically higher over the past decade, and the current recession may have been more manageable for both consumers and corporations. All of these biases help to inflate the growth potential and underestimate the risks of the U.S. economy. Unfortunately, there is always a day of reckoning. We are seeing part of that now as banks understand the word risk again. The U.S. may pull out of the current recession by year end, but the business cycle will become significantly more volatile moving forward. If larger macro-economic issues are not addressed in earnest, we will likely see shorter periods of expansion and deeper recessions in the coming business cycles.

The headwinds for corporate earnings and macroeconomic growth are fierce, but the headwinds facing individual investors are even greater. Since the early 1980's, investors have been told to buy-and-hold, believe in efficient markets, and simply trust that their portfolios will grow over time. As the baby boomer generation is getting closer to retirement, time is running out. In the past 10 years alone, the markets have proven to be anything but efficient as the stock market has worked through two massive bubbles that have shaken the foundations of free market capitalism. The simple truth is that the markets move from bull market cycles to bear market cycles and back again. Investors must think differently and overweight tactically based trading strategies while waiting for the current bear market cycle to run its course. We believe it will be many more years before we move through this mess given the lack of corporate and government accountability. There is without a doubt a place for buy and hold investing, but the current recession has proven once again, that this is truly a trader's market.