The Long & Short of It
Quarterly Newsletter
Fourth Quarter 2011

The Formidable Force of Fear

There was plenty of bad news floating around the world during the fourth quarter of 2011: concerns about China slowing down, Europe sliding into recession, the potential failure of the Euro and/or European Union. Despite these concerns, there were signs of continued progress for the ongoing recovery in the United States.

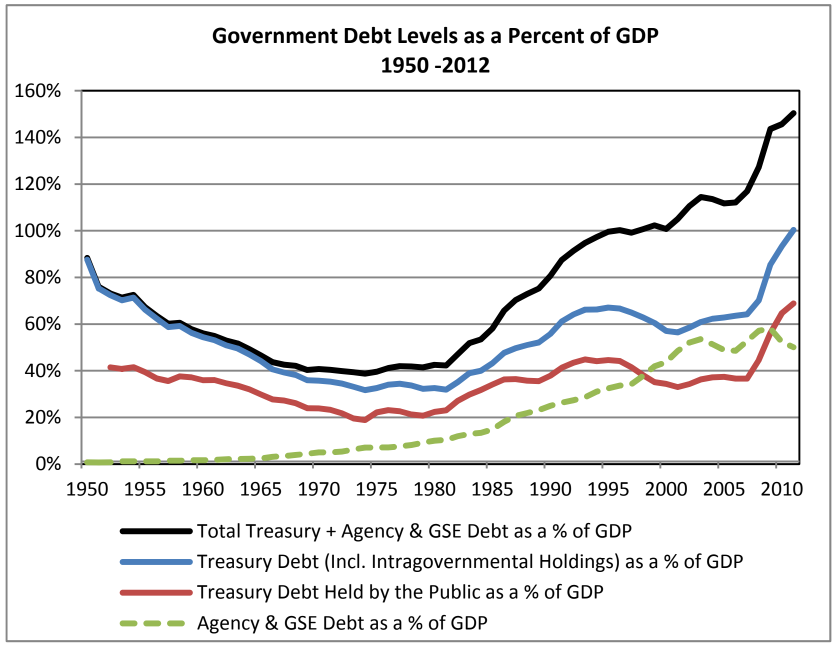
In the fourth quarter, the domestic stock market, as measured by the S&P 500, rose 11.2% bringing the full year up to near break-even. Large stocks outperformed small stocks, delivering slightly positive returns versus the slightly negative returns for small stocks. International stocks as measured by MSCI World Ex US fared worse, declining 12.2% for the full year. The shining stars for the year were domestic bonds, returning, on average, a bit over 5% to investors. Two features, high quality and long duration, paid off handsomely in 2011. Long-term government bonds returned close to 33% as expectations for future growth in the US economy fell and safety was pursued in light of the European Union's gyrations.

The wild-card of how the European Union works out its debt problems has yet to be played. As over-indebted European countries work through their problems, investors should see increased volatility as markets digest future downgrades and ever-tightening liquidity. Both in the US and EU, increased volatility may ensue as politicians make the hard decisions necessary to correct the structural challenges faced by the industrialized world.

Sovereign's Subprime Moment

A key assumption which led to the fall of the subprime market and the ensuing financial crisis was the AAA credit rating afforded to most agency and government- sponsored entity (GSE) debt. These debtors' "willingness and ability to pay" fell well short of the historic requirements to earn the AAA label. Despite numerous non-AAA metrics—including significant leverage, low equity, low income relative to mandatory debt payments, modest documentation, and little recourse—the "implied" guarantee of government support to Fannie Mae and Freddie Mac, along with the historic strength in housing prices, convinced the industry that the GSEs deserved a AAA rating. The billions of dollars spent by the US government since 2008 to keep many of these agencies afloat provide significant evidence that the guarantee is more than just implied. Conjuring capital, by printing money and thus artificially supporting Fannie and Freddie, seems more attractive to the government than disappointing its creditors.

Ten years ago, after decades of rapid issuance of agency and GSE debt, more of this kind of debt was held by the public than US Treasury debt. Since the credit crisis, agency and GSE debt holdings have declined while Treasury debt has surged. Including intra-governmental holdings of US Treasury debt, total government debt as a percent of GDP has exploded well beyond levels seen at the end of World War II. This exchange of GSE debt for treasuries has resulted in our government's balance sheet being quite leveraged, so much so that the Standard and Poor's Rating Agency downgraded the credit rating of US sovereign debt from AAA to AA+ in August of 2011.



Source: Federal Reserve Flow of Funds and the US Treasury.

The credit ratings agencies—S&P, Fitch, and Moody's—have always had an inherent conflict of interest: the entity receiving the rating (such as Fannie Mae or General Motors) is also the customer that pays for the rating. In other words, companies and/or GSE's "shop" credit rating agencies for the highest rating and those who issue the rating get paid to rate the credit. Understandably, because of this conflict of interest, the ratings agencies historically report good news regarding their customer's ratings quickly while waiting patiently/hopefully for improvement when faced with bad news. Effectively, this translates into what we have experienced for decades: when it comes to reporting bad news, the ratings agencies are reliably late. This pattern recurs with many, many companies before WorldCom, Enron, Fannie Mae, GM, and the sub-prime mortgage issuers.

It is human nature to not want to hear bad news and, in response, to shoot the messenger. Credit ratings agencies seemed indispensable for Wall Street, investors, and the government when the news was good. For example, ratings requirements were written into numerous banking laws, Basel capital standards, and investment policy statements. Today, with bad news arriving about the credit quality of the US Treasury, the foundation of our credit system, many factions seek to vilify and/or remove the credit ratings agencies from the debt issuance process.

The Elephant in the Room

In finance, risky assets (bonds and stocks) are evaluated via comparison to a theoretical risk free rate. For most of the last century, this "risk free" rate has been represented by the yield curve on debt issued by the US Treasury. US banks, and many banks around the world, meet capital requirements primarily or in large measure with the AAA rated debts that contain explicit or implied support of the United States government. As the prospect of the risk free asset becoming perceived risky becomes more likely, it threatens long-accepted applications of investment theory. The risk free rate is a theoretical construct. There does not have to be an actual risk free instrument for Modern Portfolio Theory to work. But it sure is a lot easier to do the work if everyone agrees that the Treasury yield curve represents that rate.

With more downgrades likely to ensue, policy responses have fallen into one of two categories: 1) improving the finances of the US Treasury through fiscal discipline which will make Treasuries more attractive to investors, and 2) regulating investor behavior to encourage the purchase of Treasuries over other investment options. We prefer the first option but find that more activity is taking place in the realm of the second.

After Standard & Poor's rating agency lowered the long-term rating of the US government from AAA to AA+, the Federal Reserve provided guidance to banks, savings associations, and credit unions—collectively, banking organizations—stating:

> *“For risk-based capital purposes, the risk weights for Treasury securities and other securities issued or guaranteed by the US government, government agencies, and government-sponsored entities will not change. The treatment of Treasury securities and other securities issued or guaranteed by the US government, government agencies, and government-sponsored entities under other federal banking agency regulations, including, for example, the Federal Reserve Board's Regulation W, will also be unaffected.”*

How low must the US Treasury rating fall before the Fed changes its view? On December 5, 2011, the FDIC, the Federal Reserve, and the Office of the Comptroller of the Currency unveiled a proposal to allow the largest banks to stop relying on credit ratings to evaluate the risk of assets they hold in their trading accounts. They would replace the ratings, used to help determine how much capital banks must hold against potential losses, with their own calculations of risk. Some are claiming the Fed should always treat government paper as AAA, because the government can always print more dollars to meet its obligations. In other words, for dollar-based investors the US should always be AAA, no matter the finances. Other countries have tried this approach before, with less than ideal results for the value of their currency.

Credit-rating agencies remain under fire especially in Europe, following several countries’ downgrades of their credit. *The Guardian* title for one article claimed “EU Declares War on Agencies as Ireland's Rating Gets Junk Status.” European Union commissioner Viviane Reding said the ratings agencies' "cartel" should be "smashed up" as they were seeking to determine the fate of Europe and its single currency. The commissioner in charge of the EU's single market, French politician Michel Barnier, said he would announce "stiff measures" in November aimed at taming the power of the agencies. The agencies would be forced to justify their decisions by revealing the details of their analyses and criteria.

The outrage of policy makers is driven by the credit-rating agency “messengers” simply stating their opinion that government’s “willingness and ability to pay” is not what it used to be, facts that reduce the government’s access to low-cost sources of borrowing. Fiscal restraint appears to be a difficult accomplishment these days, so creativity is being exercised in other approaches to the problem. In addition to the activities described above, we have seen proposals to mandate Treasuries as required options in retirement plans. We would not be surprised to see tax-advantaged status being offered for owners of Treasuries at some point. In fact, we will not be surprised to see actions similar to the trade protectionism that took place during the Great Depression, but applied to credit. Watch for more politicians offering reasons to own Treasuries and/or ignore the ratings agencies, but do not expect the problem to go away.

Managing the Elephants

At Robinson Value Management, we continue to develop strategies and invest in instruments with these realities in mind. Protecting and growing the purchasing power of client portfolios with limited vulnerability to downward price fluctuations remains our utmost goal. It means participating in the wealth creating process by putting capital at risk, but in prudent ways: taking advantage of known risks and protecting against uncertain outcomes. Volatility, rather than something to be feared and eliminated, must be viewed as the market's pulse, opening windows of opportunity for prudent investment. For us, the old adage "Buy low, sell high" remains as evergreen and avant-garde as on its first hearing.

For many of the companies in which we invest, it means engaging in traditional security selection techniques, with a bias toward industry leaders selling at low multiples, reflecting a recent price drop and out-of-favor disposition from the majority of investors. At a human level, it means providing capital to people when their means of engaging in their life's work is quite unpopular with the investment community. It means believing in people when they are down. When employees are willing and able to dig deeply into the creative and diligent gifts that drive humanity forward, we believe the investment, and our vote of confidence in these out-of-favor companies will be rewarded.

In the end, it is never just about money, a line, or a number on a page. It is about people and their desires to create, produce, and barter in order to make their world a better place. In uncertain times, and over the long run, ownership of real companies making real products for the global marketplace and paying real dividends remains the best way to preserve and grow your purchasing power. Of increasing importance, in light of today's shifts in the economic and political environment, is being able to protect client portfolios against some of the adverse currents in the market. Participating in the wealth building process should be as painless as possible.

Charles W. Robinson III, CFA
