



The Long & Short of It

Quarterly Newsletter

Third Quarter 2012

The “Fiscal Cliff” and Investment Portfolios

The “fiscal cliff” refers to a large mandated reduction in the federal budget deficit along with a corresponding projected slowdown in domestic economic activity that might occur if specific laws are allowed to automatically expire or go into effect in January 2013. These laws include tax increases due to the expiration of the Bush tax cuts and spending reductions (“sequestrations”) required under the Budget Control Act of 2011.

Sequestration would make the eventual and inevitable slowing of economic growth happen sooner. Few will want to fall off the fiscal cliff so, after some scares, compromise will be likely. Whatever Washington’s likely modest accomplishment will be, any compromise will be hailed as a major bipartisan achievement leaving, in the short run, the potential for a market rally (asset inflation) and eventually increased price inflation.

Systemic Challenges in Today’s Markets

Frustrated with the current market environment, on August 1, Louis Moore Bacon explained to the *Wall Street Journal* why he returned \$2 billion of his \$8 billion hedge fund to his investors:

Government intervention in markets has distorted them to such a degree that finding profitable investment opportunities had become difficult. The backdrop of over-indebted developed-market economies, coupled with unprecedented efforts by central banks and policy-makers to jolt those economies, has created “short start-stop-start growth cycles that exacerbate trendless volatility,” hurting profits.

On September 10, 2012, the *Financial Times* ran an article titled “End to ‘Alpha’ a Stress for Fund Managers,” saying:

It is no secret that investors of all stripes have struggled to beat the market since the financial crisis. Much of the blame for this tends to be attributed to the fact that markets now move to a drumbeat of statements from politicians and central bankers, such as the head of the US Federal Reserve. “All 500 S&P companies have the same chairman and his name is Ben Bernanke,” says Jurrien Timmer of the Fidelity Global Strategies Fund.

On September 18, 2012, Goldman Sachs’ Chief Financial Officer, David Viniar, said on an analyst conference call,

Anytime you ask me about the biggest risk the firm faces, you’re always going to hear me give the same answer, which is: liquidity, liquidity, liquidity.

Challenges faced by investors over the third quarter, and really since 2008, have created much frustration among professional investors. It seems as if the skills needed to select securities for much of the preceding three decades do not apply today. Increased volatility; heightened use of leverage by the Federal Reserve; pricing distortions caused by manufactured interest rates; policy influence on labor participation and utilization; increased government regulation pushing investors into smaller, more private, illiquid investments; return-starved investors’ pursuit of high-risk strategies such as small cap stocks, real estate, and high yield bonds... all of these factors conspire to create a difficult market environment.

Don’t Fight the Fed

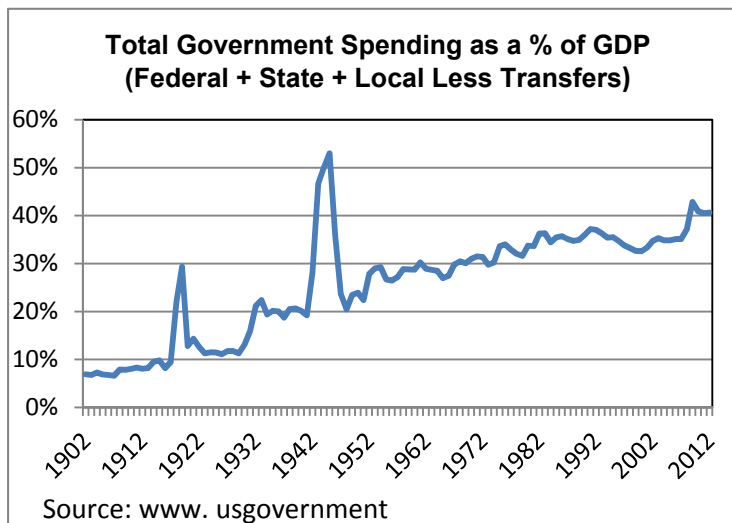
Investing in a post-crash era requires making the best of a difficult global environment. Risk and volatility persist despite, and at times because of, governments’ efforts to manage the economy. So rather than “Fighting the Fed” or even ignoring the federal government, our portfolios seek to profit from the shifts in liquidity and expectations created by a large government.

Our equity portfolios are filled with industry leaders (wide moat concept) with clean balance sheets. These highly liquid large cap domestic stocks have higher than average dividend yields and are liquid in the extreme. In addition, the smaller, more strategic portion of the portfolio mitigates risk further through actively managed allocations to a handful of highly liquid Exchange Traded Funds. In this portion of our client portfolios, we seek ETF investments that benefit from detrimental shifts in expectations for real growth, inflation, and uncertainty. Our task is to discern which threat the market currently faces while harnessing volatility to the benefit of our clients.

We do not use options or other speculative instruments that cost money to own. These are investments that one could buy and hold and generate decent returns with over the long run, but in difficult markets could also work to protect the portfolio against systemic risk. Though they are investments that are volatile and involve risk, they can work to protect against downside while, unlike long positions in options and other hedging instruments, they can earn a reasonable return if held over longer periods of time.

Are Systemic Challenges Here to Stay?

Unequivocally, **Yes**. The size and footprint of all government—federal, state, and local—are growing and hungry. The impact of our government's normal policy-making and implementation rises in influence as its size grows. As we can see from this chart, total government spending, including federal, state, and local spending, as a percent of Gross Domestic Product (GDP) continues to grow over time; rising from 11% in the early 1930s, to 20% after FDR, to as high as 30% by the mid-1950s. From about 1980 through 2007, the growth paused. Even as late as 1997–2001, it averaged only 33% of GDP. Now it has caught up to its rising long-term trend, currently comprising over 40% of our nation's economic output. Federal government spending alone runs about \$3.8 trillion per year, comprising about a quarter of the US's current economic activity (GDP of about \$15 trillion). Moreover, with federal budget deficits near \$1.3 trillion, net new borrowings alone now fund 9% of GDP, ignoring any multiplier effect.



As government policies and goals are widely known, government behavior can be remarkably predictable. In its relationship with the private sector, the need for reliability and predictability dictates that most activity is scheduled on a calendar and repeating. Finally, there is the disposition of politicians. As the MIT economist Dr. Lester Thurow said, *“Politicians predictably will choose inflation over deflation. With inflation, it is just a matter of who gets rich the quickest. With deflation somebody goes broke.”* At Robinson Value Management, in addition to traditional investment management that focuses on loss aversion, our goal is to help investors manage and profit from the systemic risks found in a managed economy where government spending is a large portion of overall economic activity.

How Virtuous are Our Politicians?

They say that fiscal responsibility is a bit like protecting one's virtue—you have to learn to say **“No.”** Whether ahead of us lies the fiscal cliff (much belt tightening) or a bipartisan agreement (moderate belt tightening), there appears to be little that'll create the rising tide that lifts all boats. With some portion of their portfolio, investors need to be nimble, seeking to benefit from the ebb and flow of expectations between inflation and economic growth. We hope you can enjoy the end of the election season. Have a peaceful and productive fall of 2012.

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