



## Commentary

by Steve Henningsen

April 2005

### Nature's Way

*"Yesterday's weeds are today being priced as flowers."*

Warren Buffett

Spring is here at last! Not that winter is all that long here in Colorado, but this is my favorite time of the year. The days grow longer and the sun's expanding warmth causes last year's seeds to burst forth from the soil and color the landscape again. As some of you already know, I like to garden. I realize this isn't the manliest hobby—as my snickering male friends like to remind me—but it makes me feel better in some nurturing way.

I'm not sure where my interest came from, as I wasn't raised on a farm or by parents who were big gardeners—although Dad liked to putter in his vegetable garden. Maybe it is the short, recurring lifecycle of plants, like much in nature, that draws me. In one year's time they grow from vulnerable children to mature adults, and before succumbing to the harshness of autumn, responsibly spread their seeds from which the next generation will reach skyward.

My interest in gardening may also have to do with the parallels I see with investing. Both work in cycles and the littlest change can have large ramifications, even if not easily envisioned in the short-term. Was it mere coincidence that one of the largest investment crazes, the Dutch tulip bulb mania, which gripped the Netherlands in the 1630's, involved a plant?

When Lana and I moved to Colorado from Boston, the house we bought was newly constructed and, therefore, came with no landscaping. Given a blank slate, we could have done what most new homeowners do and simply hire someone to come in and plant the conventional instant landscape (rolled out Kentucky bluegrass and a few shrubs and trees). Similarly, many investors seem to setup their investment portfolios based upon their neighbors' or relatives' advice, as investing alongside the herd makes one feel safer and takes little effort, just as having one's landscape not stick out in the neighborhood makes one feel a sense of belonging.

However, we didn't want the prototypical yard and desired to use plants native to our new state. We are dumfounded by the number of people who move to Colorado from somewhere like California and believe they can plant the same species that grew so well in their former states. They don't seem to realize (until they have killed off a few plants) that they need to consider their new environment before selecting plants. In the investment world, when the environment of the markets changes (interest rates, currencies, liquidity, demographics, etc.), investors scratch their heads and wonder why their investments that performed so well over the past several years don't seem to be as fruitful in their new surroundings. Not until their portfolio has wilted do they feel an urgency to make changes.

*“People experiencing long periods of relative stability are prone to excess.  
We must thus remain vigilant against complacency.”*

Unknown

The decade of the 90’s was deceiving to gardeners in western states and investors alike. Above average precipitation and investment returns in U.S. stock markets lulled Coloradoans into believing their arid landscape had returned to its Jurassic roots and that stocks effortlessly made millionaires at the click of a mouse. But in 2000, drought returned to both the west and the stock markets. This didn’t surprise those scientists who studied Colorado’s history through several centuries of tree-ring growth and, therefore, knew the likelihood that it was all a mirage. Likewise, historians of the investment markets knew that “trees don’t grow to the sky” in the investment world either, nor should investments be made today based upon yesterday’s “weather.”

To improve the probabilities of success when designing our landscape, we took what are referred to as “micro climates” into consideration prior to selecting our plants. For example, drought-tolerant wild flowers should be planted on the south side of the property and shade seeking, thirstier plants on the north side. Asset classes are the “micro climates” of the investing world and need to be taken into consideration prior to choosing your investments. Personal preference finally comes into play when selecting the plants/asset classes for implementation. Not everyone wants sunflowers; nor does every investor want emerging markets growing in their portfolio.

In both gardening and investing, patience is a tool everyone possesses, but seldom uses. We realized that soil in Colorado is generally poor and, therefore, spent time and money improving the soil prior to planting. (We probably spent more money on improving the dirt than most spend on the whole yard, but we knew it would pay off in the long-term.) This, and the fact that we used a mixture of both native grasses and wild flower seeds to sow the yard, meant we waited almost *two years* before seeing a single flower. We could have purchased mature plants, but it would have been much more expensive and not come out as natural looking. Our willingness to endure was tested at times—looking at our dirt lot and then gazing across to our neighbors’ lush green lawns was not easy. Last spring our fortitude was rewarded with a flowing river of wildflower colors, surrounded by a mote of swaying ornamental grasses about our house.

My observation is that most investors aren’t interested in buying seeds, as they don’t want to wait years before they see a flower. They will pay a high price for a well known company’s stock, a mature plant: even though most of the bloom may have already passed, at least they have something to show for it today.

The work does not stop once the garden or investment portfolio is established. If one does not thin out those flowers that thrive, they will quickly choke out the chance of the others’ day in the sun. Likewise, if one’s portfolio is not rebalanced, one asset class’s returns may swamp the performance of others. Just as too much fertilizer may be harmful and spawn weeds, interest rates kept artificially low for too long may stimulate pockets of excess investment, choking off future economic growth. If a shrub, grown dense and feeble with age, is hacked back it will respond with new growth and vigor; and similarly, if creative destruction is not allowed to take root in the capitalist world, inefficient companies will prevent desirable industrial mutation.

*"Our country that is now aspiring to an 'Ownership Society' will not find happiness in – and I'll use hyperbole here for emphasis - a 'Sharecropper's Society.' But that's precisely where our trade policies, supported by Republicans and Democrats alike, are taking us."*

Warren Buffet from Berkshire Hathaway's Annual Report

We can also learn a lot from farmers. They know that even fertile grounds, if over-farmed, will yield less over time. So constraint is shown and the old is plowed under to make way for the new. Although both farmers and investors know of the biblical story of seven years of drought followed by seven years of harvest, only the farmers seem to heed the warning by saving up during the bumper-crop years. The American consumer doesn't seem to remember the last drought and, consequently, is ill prepared for any change in the weather that may lie ahead.

I realize that many are relying on the greatly appreciated value of their houses for shelter from potential storms, but they will have to sell their homes and move somewhere with a lower cost of living to come out ahead. For many, I presume this will be more difficult than imagined, since not everyone will desire a retirement home in Kansas (except a farmer, I suppose). Anyway, does a home really bring wealth since it produces neither a dividend, nor yield? Some believe it should be looked upon as a non-productive asset. If it were suddenly fashionable to own a farm and the value of farmhouses skyrocketed across the country, would the farmer's wealth have really increased? In economic terms, has the farmhouse's utility increased or is it still a bunch of sticks and stones cobbled together? Will it lead the house to be more productive in the future? In the farmer's eyes, is it the production of fruits and vegetables that brings him wealth or his consumption of things? I'm not sure about many of these things, but these will be interesting years ahead.

**And now back to the news...**

### **Reality echoes from the Empire State**

*Debt has become a crutch for the State. It has been utilized all too often, for objectionable purposes, and has become an easy answer to solving the State's fiscal woes. The State faces hard choices and a difficult road with such a reform proposal. It is very important that those choices be the result of open, honest and informed discussion among policymakers and the public. Additionally, it is equally important to inform the public of decisions about and the status of debt management in the State. Debt is currently affordable only because the State is capable of providing enough funds to pay annual debt service. Simply having enough revenue does not mean that debt management is cost effective for current or subsequent taxpayers. The primary problem with the current structure is that too few really understand the depth of the problem, and even fewer have the inclination to institute change. The reform will be somewhat painful, but real reform is the right thing to do.*

The paragraph above is from the conclusion section of the New York State Comptroller's latest debt report. I imagine how it would sound with the word United States substituted for "State" and the words flowing from the mouth of President Bush at the State of the Union Address. I won't rant on for my typical two pages regarding our country's debt problem, but suffice it to say that the US has become the world's portly, funny drunk at the party. Everyone enjoys this character, but ponders privately the long-term effects of his lifestyle. Our international friends realize our spending behavior and deficits are not healthy for us, but hey, they get to benefit from it (selling us the booze) and hopefully won't have to deal with the associated problems after the party comes to an end.

And if Social Security's and Medicare's unfunded liabilities weren't depressing enough, now I read that The American Society of Civil Engineers 2005 Infrastructure Report Card gives the US a grade of D and talks of a looming crisis absent \$1.5 *trillions* in emergency repair. This shouldn't surprise anyone who has taken a moment to look upward at the rusty underbelly of any bridge they drive under or downward at the minefield of potholes scattered about the roads.

### **Oh, did I say that?**

*"The abandonment of the gold standard made it possible for the welfare statists to use the banking system as a means to an unlimited expansion of credit. In the absence of the gold standard, there is no way to protect savings from confiscation through inflation. There is no safe store of value. Deficit spending is simply a scheme for the 'hidden' confiscation of wealth. Gold stands in the way of this insidious process. It stands as a protector of property rights. If one grasps this, one has no difficulty in understanding the statists' antagonism toward the gold standard."*

During Alan Greenspan's testimony before Congress in February, Congressman Ron Paul read him the above quote. He then reminded him that it was his own words from 40 years ago when he wrote in favor of a gold monetary standard and the fundamental problem with fiat currencies in an essay entitled Gold and Economic Freedom. He responded that he was wrong in his belief back then and that the Federal Reserve does a good job of essentially mimicking a gold standard, and that inflation is well under control. He is certainly entitled to change his mind; however, I feel the jury is still out on whether his initial thinking was incorrect as his fear of "unlimited credit expansion" seems to have met with reality.

I would also believe that former Fed Chairman Paul Volcker would disagree with the cheery sentiment thrown about, as his words at a recent conference, held at the Stanford Institute for Economic Policy Research, paint a different picture: "*Below the favourable surface, there are as dangerous and intractable circumstances as I can remember... Nothing in our experience is comparable... But no one is willing to understand and do anything about it... We are consuming... about six percent more than we are producing. What holds the world together is a massive flow of capital from abroad... it's what feeds our consumption binge... the United States economy is growing on the savings of the poor... A big adjustment will inevitably become necessary, long before the social security surpluses disappear and the deficit explodes... We are skating on increasingly thin ice.*"

### **Delusional Fed**

*"We can guarantee cash benefits as far out and at whatever size you like, but we cannot guarantee their purchasing power."*

Alan Greenspan, in his recent testimony before Congress

*"Having won supervisory control over the entire financial services industry, the Fed must bring into the light where the markets can see them continuously the now hidden maneuverings of the private banking empires, the derivatives dealing, the over-leveraging that accompanies over-reliance on diversification and probability. And the Fed has never believed in sunshine as a disinfectant. The tragedy for all of us would be if the Fed's and the Treasury's and the Congress's reverence for people who make a lot of money left us unprotected against some sudden revelation of the truth that becomes obvious only in hindsight, that a lot of them don't know what they're doing."*

From *The Fed*, Martin Mayer

Kind of gives you that warm fuzzy feeling, huh? Speaking of delusional, a study conducted by Mathew Greenwald & Associates and the Employee Benefit Research Institute was released recently demonstrating how "well" prepared workers are for retirement. Let's see now... fifty-five percent of workers said that their savings were behind schedule, fifty-three percent think

they will only need to save up to \$500,000 for retirement, with over 60% of those thinking that \$250,000 will be enough. Oh, and 46% of respondents said they just guessed. What about the money that has been saved you ask? Across the four age demographics detailed (25-34, 35-44, 45-54, 55+), more than half had less than \$50,000 in savings. As I have stated many times before, the baby boomers are coming in for a landing on the retirement runway with their wheels up and their eyes closed.

## Investments

A time to be born, a time to die

A time to plant, a time to reap

A time to kill, a time to heal

A time to laugh, a time to weep

*Turn! Turn! Turn*, The Byrds

We began the year by bidding adieu to an old friend, Morgan Stanley's Institutional US Real Estate Fund. It wasn't easy since we've been partners since the late 90's and they ended 2004 with a peer-envious 37% gain. However, my inclination was that the bloom was off the rose in the US REIT market. That's not to say we are completely out of the real estate sector, as I added a small allocation to Alpine International Real Estate Fund to portfolios. We may return to our old friend some time down the road.

We also greatly pruned back our positions in domestic small cap stocks, specifically our weightings towards our various DFA small cap holding. While providing excellent returns for us over the past few years, I wanted to further reduce our U.S. small cap stock weighting, while at the same time adding another fund, Third Avenue Small Cap Value, to the portfolios. I've had my eye on this fund and its manager, Curtis Jensen, for some time as he, like many of the other managers added over the past few years, isn't afraid to hold cash and be defensive when necessary.

Other positions added during the quarter were the Prudent Bear, US Global Resources and the Central Fund of Canada funds. The Prudent Bear Fund makes money by predominantly shorting the market (makes money when the stock market goes down) and was added to buffer any market downturns in the months ahead. The US Global Resource Fund invests in companies in the commodity sectors (oil, gas, coal, iron ore, etc.) and the Central Fund of Canada Fund invests in gold bullion and silver bullion (50/50). Although, there are less expensive ways (gold ETF's) to invest in gold bullion, this is the only investment I've located that also invests in silver bullion. Although the gold and silver markets have not performed well recently, I believe our positions tucked neatly under our pillows will allow us to sleep better in the years to come.

While both bond and stock markets lost money for the quarter, we were fortunate to eke out a small gain. This was largely due to our overweighting of the commodity and energy sectors as Vanguard Energy led the way, up over 14%. Suffice it to say our heavy weighting towards commodities, or as investor Dennis Gartman likes to say, "*things that hurt when you drop them on your foot*," have given us a nice boost over the past few years. Although I believe the long-term trend is still up in regard to these tangible investments, we will face pullbacks as hedge funds' and speculators' comings and goings are adding to the volatility in these areas. As I write this in mid-April, the energy and commodity markets have already given up some of their gain for the year.

I find it rather comical that some of the same Wall Street analysts who didn't see any technology bubbles in the 90's, have been spouting that they fear a commodity bubble has formed. How technology companies—companies with little barriers to entry and products that we want, but don't need—can be compared to companies that produce things we need (oil, cement, steel, etc.) and have very long and expensive start-up costs, is beyond me. New software programs are being developed all the time and increasingly in cheaper-labor-rate countries such as India. However, something like oil takes approximately a million years to produce, and since we haven't built any new refineries in the U.S. in the last 25 years, we are having a bit of supply problem given Asia's increasing thirst. Oh, and then there's that issue of profits, which commodity companies have lots of while the internet companies of the 90's had none or very little of—some of which turned out to be fictitious to boot. As I've said before, it is simple Economics 101, supply and demand, and over the next several years the scales will tilt towards demand.

### **Final thoughts**

*“Investors want to believe in an “expert”, in the same way the sick will often believe in a faith healer. They want a clear opinion about the future direction of the investment markets, without any recognition of the fact that, at least 50% of the time, deference to such views will lead to significant losses, as, no matter how diligent we “experts” are, we nevertheless remain largely ignorant of the future.”*

Marc Faber, investor & newsletter writer

Given our respectful performance over the past several years, I have had many clients bestow upon me nice compliments regarding their portfolios' performance. Although I appreciate the accolades, I can't help but feel that you are being seduced by that performance. Yes, I have made some investment decisions that, in totality, have worked for the best—*so far*. But as Marc Faber points out, investing involves future outcomes amid a complex global system, and I am concerned that some may begin to increase their expectations beyond what is deliverable. I tend to function on the premise that the longer one is right about something, the closer he is to being wrong. Maybe this is what makes me more defensive these days.

On a different note regarding my commentary: I seem to write a lot about what's not working in the U.S. I believe change doesn't occur unless people speak up, rather than relying on hope to get them through problems. I guess my forum here helps me vent about some of the things I read about that concern me (and, I hope, concern others). I played many sports growing up and looking back, it was not extolling my strengths that made me a better athlete, but constantly working on my weaknesses. Nor do I not want things to work out with the American economy. To paraphrase John Mauldin in his recent newsletter, who used another sports analogy, *“I may root for my home team, even if they realistically don't have a chance of going to the World Series, but I wouldn't bet on them.”*

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