



Commentary  
by Steve Henningsen  
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### ***Trying to win the losers' academia game***



*“If a man will begin with certainties, he shall end in doubts;  
but if he will be content to begin with doubts he shall end in certainties.”*

–Sir Francis Bacon

A quarterly review of TWC’s performance over the past few years would leave many newcomers perplexed. This past quarter’s performance was no different—clients experienced the mirror image of the previous quarter’s, as our defensive posture that made us appear so unwise in the first, came to our rescue in the second. One moment you’re a chump and the next you’re an adept practitioner. As usual, the truth falls in between. For our neophyte clients, I would like to take a moment to explain how our investment philosophy developed and why it can periodically deliver such strange results.

*Life is so strange  
Destination unknown  
When you don't know  
your destination  
Something could change  
It's unknown  
and then you won't know  
Destination unknown*

–Missing Persons, *Destination Unknown*

Back in the early 90’s, I can clearly remember sitting at the table across from a pleasant gentleman. Even though I was new to the investment advisor profession then (we were called financial planners back then), being an analytic, I was a quick study, and it didn’t take me long to learn how to plug the right numbers into the portfolio software to get the “optimal” model. I had just finished my presentation of his recommended investment portfolio, complete with jazzy pie charts and the *pièce de résistance*—the efficient frontier graph—and was waiting eagerly for his response. Surely, I had wowed him, as no one could deny the mathematical precision used in

creating this colorful representation between risk and reward—the Holy Grail of the perfect portfolio lay on the table before him.

He was quiet and attentive throughout my discourse, but now he looked at me with a fatherly eye and said something that I failed to grasp until several years had passed: *Steve, you seem like a nice guy who is very knowledgeable regarding investments. However, there is a difference between knowledge and wisdom, and you are too young to have the latter.* He then walked the befuddled advisor politely to the door.

*"Thinking you know when in fact you don't is a fatal mistake,  
to which we are all prone."*

–Bertrand Russell

Flash forward to 2002, and Steve is handing out *Winning the Losers Game* by Charles Ellis to many TWC clients, as we practiced mostly a “buy and hold,” passive (index) investment philosophy, and Mr. Ellis’s book outlined all the ivory-tower reasons why this was the *only* method to winning the money-management *game*. Now, by this time we had just completed two brutal years in the stock market—the technology bubble had popped and investors were being reminded that earnings actually do matter. However, even as I believed his philosophy, doubts were beginning to creep into my mind, because real world events were gnawing at my set of beliefs. If markets were so efficient, why did bubbles form periodically? Did it really make sense to not factor market psychology and macroeconomic/investing trends into one’s investment strategy, given that market movements were supposedly random? If markets trade in secular and cyclical cycles, does ignoring them and sticking to a “buy and hope” strategy make sense? Does relative performance matter, for isn’t a loss a loss?

*To penetrate and dissipate these clouds of darkness,  
the general mind must be strengthened by education*

–Thomas Jefferson

It was during this time that I began diving into financial history books, beginning with Marc Faber’s *Tomorrow’s Gold* and Charles Kindleberger’s *Manias, Panics, and Crashes*. (On a side note—Mr. Kindleberger once claimed that academics too often ignore the facts in defense of a theory.) It would mark the start of an eye-opening, intellectual excursion from which I hope never to return. Over the next 12 months I poured over countless books and newsletters, absorbing information, even if it went against the rigid thoughts that I had at the time—I was finally open to that experience human beings resist from their core: *change*. One of the most important things I learned is that there are periodic shifts occurring in the investment world that change the *game*. One moment you are playing tennis and the next you find yourself on a squash court. Now, if the game has changed, shouldn’t the rules change as well? Not according to the academics, whose perfect-world models are only set up to play the game of tennis and, therefore, become baffled when a squash ball comes rolling down the court—must be an outlier event, or “black swan,” as they’re known today!

*"There is something wonderful in seeing a wrong-headed majority assailed by truth."*

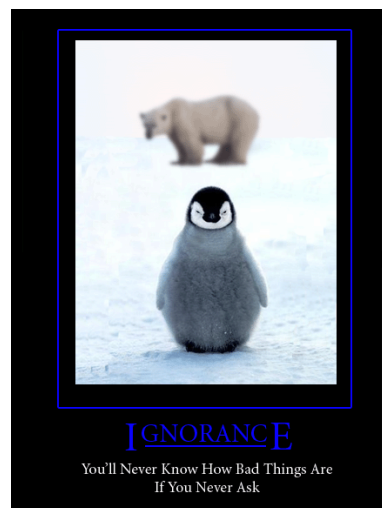
– John Kenneth Galbraith

*A willingness to be contrarian is also vital. You will inherently be doing the opposite of what everyone else regards as sensible. Being a contrarian involves three separate elements: 1) having the courage to stand against the*

*dominant view; 2) being an independent thinker; and 3) having the firmness of character to stick to your guns. All three of these traits are unnatural of human beings!*

–James Montier, GMO

Like the little kid that began to doubt the existence of jolly St. Nick, things finally began to make sense. I had to unlearn much of what I had been taught in business school, theories considered sacrosanct in much of the investment community. The veil that covered up the efficient-markets hypothesis fell to the ground, as I began to realize that much of what academics preach from their ivory towers go against real-world experience. *Human beings are rational creatures!* How could I not have seen the falsehood of that one? Slowly a long-repressed inner sensation began to come back, something often discussed but seldom used in these times—common sense. Allowing this to move to the forefront of my thought process, while opening my mind to various points of view, gave me the confidence to begin thinking “outside the box” and helped me feel more comfortable walking away from the herd mentality that enveloped my profession.



*"When the facts change, I change my mind. What do you do?"*

–John Maynard Keynes

*"They are measuring what is measurable, not what matters."*

–Friedricj Von Hayek

The culmination of that growth period in my life came about with my first commentary, *Standing at the Crossroads*, during the 2<sup>nd</sup> quarter of 2003. I had realized that the investment environment had changed and that I had better be proactive if I wanted to prepare for what I believed lay ahead. In my commentary, I took clients through the past, present and what I thought the future investment landscape might look like. We would leave the familiar quantitative, passive world of investment management for a more uncertain, intuitive one—an environment that relied more on art than science. I was also beginning to use investment managers that had a more *contrarian* philosophy, managers that had a global investment palette and who weren't constrained by a “box” mentality. We would focus more on absolute performance vs. relative performance.

*Freedom is threatening because it eliminates the possibility of shifting responsibility for your errors onto others. Freedom puts you right out in the open, with no cloak for your mistakes. It also gives you full credit for your successes, but that is seldom considered, as the fear-based impulses are generally stronger.*

– From Paul Rosenberg's, *A Lodging of Wayfaring Men*

I knew at the time that I was asking a lot of our clients, because this was a major transformation from our past methodology. I also knew that I was exposing myself to the largest, yet least discussed, risk in my profession, a risk one of my heroes in the investing world, Jeremy Grantham, calls “career risk.” If one stands within the crowd and is wrong in his judgment, then it is usually excused, as most others were wrong as well—a.k.a. relative performance. However, as soon as he moves away from the herd and onto the open plains, where only lonely contrarians roam, he would be vulnerable to criticism. Out here there are no crowds to hide within.

Being accepting of the contrarian ways also requires another rare element of human nature, patience. Contrarians tend to be early to the party, having to deal with the boredom and awkwardness of standing in a vast empty room. Then clients have to accept that just before midnight, when the party is getting going, you have to leave. What I have found over the years is that our clients are very tolerant of those periods when our performance seems out of sort. I surmise that this tolerance is due to the fact that we constantly communicate our thoughts to clients—right or wrong—and explain why we are allocating a part of their precious capital in a particular sector or theme.

*I'm only happy when it rains  
I'm only happy when it's complicated  
And though I know you can't appreciate it  
I'm only happy when it rains*

*You know I love it when the news is bad  
And why it feels so good to feel so sad  
I'm only happy when it rains*

– Garbage, *I'm Only Happy When it Rains*

Another aspect of being a contrarian—or a realist, as I refer to it—is that people often think you are a pessimistic person. I think this derives from the fact that for the past several decades Americans have seen pretty good times, and expectations are that they will continue. Those of us who point out that the ingredients that helped bring about those “good times” don’t exist today, are ridiculed. (I have never said these conditions couldn’t return!) In addition, the investment industry naturally has a positive bias, as investment firms don’t want to spook their asset base, so most naysayers are branded “bears” or Cassandras.

*Wealth preservation over the next five years should be the single most important investment objective of almost everyone. This requires a plan, serious study and thought, patience, objectivity, prudence, and a strong resistance to running with the herd. There is a lot of money sloshing around the world as a result of the Great Reflation, and periodically this will find a home in various asset markets, pushing prices to unsustainable levels . . . However, the underlying footings of the economy will remain weak, and asset prices cannot levitate indefinitely on hope and momentum alone. Severe shakeouts will be a fact of life. Gains will be difficult to keep, and losses easy to come by. Living standards and wealth could be under pressure for years.*

– J. Anthony Boeckh, *The Great Reflation: How Investors Can Profit From the New World of Money*

So here we are back in 2010. The U.S. stock market has lost money over the past decade, while the past three years alone have seen enough “black swans” to block out the sun. Europe’s in disarray (don’t believe their upcoming, phony, bank stress test); deflation and inflation are still battling it out; austerity is all the rage; China may or may not be in a bubble; U.S. Treasury bonds are selling like hotcakes, even though most thought them overpriced (including *moi*); states and municipalities are broke; and the Tea Partiers—pitchforks in hand—are ready to knock the hinges off the doors of Congress. All in all, TWC’s approach to wealth preservation has performed fairly well. By taking into account market psychology, valuations, and macroeconomic conditions, while focusing on risks, we managed to dodge some of the cream pies thrown in the air. That’s not to say we didn’t have to wipe some lemon meringue from our face occasionally. This is truly a humbling profession, and I made mistakes over the past several years, which I hope not to repeat. I have painted a pretty bleak picture, but it is the truth of what I see out my windshield, as we drive forward into tomorrow.

*Put on your green lights  
We're in the city of wonder  
Ain't gonna play nice  
Watch out, you might just go under  
Better think twice  
Your train of thought will be altered  
So if you must falter be wise  
Your mind is in Disturbia  
It's like the darkness is the light  
Disturbia  
Am I scaring you tonight  
Your mind is in Disturbia  
Ain't used to what you like  
Disturbia  
—Rihanna, *Disturbia**

TWC clients know that I don't believe the danger is behind us—how could it be? After the worst financial crisis in 70 years, two years later little has been fixed. We have more debt after wasting trillions of dollars on so called *stimulus*, while the crooks that helped steer the financial system off the tracks are still behind the wheel. But one of our investment managers, John Hussman, states it so much better: *A dollar spent by the government is always a dollar taken from somebody and diverted from some other activity. The only question is whether the dollar spent is more productive, or satisfies a more desperate human need, than the alternative activity would. If not, the spending is hostile to economic growth and public welfare. There is no free lunch. At best, what people call "stimulus" can only occur if the dollars spent by government are more productive than they would have been if they were allocated privately. I cannot imagine how allocating public funds to the same reckless stewards of capital that made the bad loans in the first place can possibly be a productive use of capital...In short, instead of directing savings toward investments in real, productive assets that we would observe as physical output, fixed capital, and equipment (and claims on those assets in the form of corporate stocks and bonds), our economy has been forced to choke down a massive issuance of government liabilities in order to bail out bad debt. For every dollar of debt that should have defaulted, we now have two dollars of debt outstanding (the original debt, and a newly issued government security). What appears to be "sideline cash" is simply the evidence of past spending. Again, the crucial consideration is how the government spent the funds in the first place. Rapidly mounting evidence suggests that the answer is "not very well."*

### **Portfolio Happenings!**

*Providing that one can be patient and contrarian, there is simply no reason why strategic asset allocation implies static asset allocation. Changing the asset mix of your asset allocation in response to the fluctuating opportunity set offered by Mr. Market seems like common sense to me. Sadly, of course, common sense tends to count for little in the world of high finance!*

—James Montier, GMO

Once again, this quarter's positive performance needs to be put into perspective, given our underperformance in the first quarter, as we continue our separate path from the stock indexes. Our reverse ETFs (short the underlying index), underweighting to equities and our large exposure to precious metals all helped us keep afloat this quarter. We were also assisted because I changed my mind and sold our position in the ETF that shorts the U.S. Treasury market. (I had

come to the conclusion during the quarter that over the short term, deflation would win out over inflation.) This proved fortunate, as the U.S. Government bond market rallied during the quarter.

During the first week of July, I reduced the number of reverse ETFs in our portfolios, as I expect a short-term bounce for the next few weeks. I also sold our volatility play (VXX) for a quick gain and reduced our precious metal stock exposure by selling GDX and GDXJ. I am still very positive on precious metal stocks, but we had over 10% allocated to this area and I wanted to reduce the risk of a summer pullback in the gold and silver markets. I envision buying them back soon. However, should the precious metals market continue its upward trend, we still have exposure via our core precious metals mutual funds, Tocqueville Gold and U.S. Global Investors World Precious Minerals.

*"Life is not a matter of holding good cards,  
but sometimes, playing a poor hand well."*

—Jack London

With the housing market turning down once again, the pension and commercial real estate crises still ahead, consumer credit growth slowing and the sovereign debt situation still not resolved, I feel the markets will continue their bipolar mannerisms going into 2011. There don't seem to be many good cards out there, but I will continue to do my best to keep us in the game, no matter poker, tennis or squash!