PRICEVALUEPARTNERS

Happy anniversary

"They have learned nothing, and forgotten nothing."

- Attributed to Talleyrand.

Since everybody else in financial media has been indulging in an orgy of self-reflection, selective recollection and brazen virtue-signalling on the back of the 10 year anniversary of Lehman Brothers' bankruptcy in September 2008, and in steadfast keeping with our principle of 'no bandwagon left unridden', we reproduce below, word for word, our commentary first published on 1st October 2008. A brief update then follows..

Armageddon outta here !

> "Last night, Mr Brown made it clear he was ready to increase the level at which savers' deposits were guaranteed from £35,000 to £50,000 but indicated he did not want to act until the markets had calmed."
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> – From The Financial Times, 1st October 2008.

As part of my O-level history course back in the mid-1980s, I wrote an extended essay on the topic of the atomic bombing of Hiroshima in 1945. My teacher made the useful suggestion of comparing the Hiroshima experience and related issues with those of the Dresden fire bombings earlier that fateful year. Even now I'm not sure whether either action could be easily or wholeheartedly justified and as a non-combatant (and non-civilian, for that matter) of the time in question, it still seems somewhat presumptuous even to try. What I do recall is that I concluded my study with the words of historian A.J.P. Taylor:

"War suspends morality."

I recall these words because I am now reminded of advice given me a year ago when the crumbling of the credit markets first became manifest to a financially less literate world. While I was personally wrestling mentally with the moral hazard issues surrounding banking bailouts and the like, a South African fund manager friend made the following pertinent observation: in a shooting war, don't waste time scrupling over moral hazard – the objective is survival. Politicians across the board and across the world seem dangerously unaware of the severity of this crisis, and of the risks they pose by indulging in partisan bickering when political leadership (*sic*) is so desperately needed and simultaneously so horribly deficient.

A year ago I was watching the run on Northern Rock from a hotel room in Rome. This time round – a full year into this crisis – I was watching certain members of the US Congress effectively voting for some sort of suicide pact from a hotel room in Sicily[1]. Perhaps I should be forbidden from going on holiday. But watching the venal self-interest of Republicans (and some Democrats) blooming with some disbelief, it was almost easy to paraphrase the words of Bank of America CEO Ken Lewis, in that I've had all the fun I can stand in investment management.

But one of the many benefits of a short break was the opportunity to read, and re-read, Robert Shiller's timely analysis of how we got here, 'The Subprime Solution: How today's global financial crisis happened, and what to do about it' (Princeton University Press, 2008). Professor Shiller begins his measured and constructive study of the current financial debacle with an apposite quote from the master himself, John Maynard Keynes:

> A general bonfire is so great a necessity that unless we can make of it an orderly and good-tempered affair in which no serious injustice is done to anyone, it will, when it comes at last, grow into a conflagration that may destroy much else as well.

Keynes was writing about the economic consequences of the overly punitive Treaty of Versailles imposed upon a defeated Germany in 1919. The analogy of an all-consuming fire is just as appropriate now. And I for one am getting increasingly disgusted at the sight of politicians fiddling while our entire financial infrastructure burns. The fire metaphor was also used by Henry Steagall, chairman of the House Banking and Currency Committee, in 1932:

> Of course, it involves a departure from established policies and ideals, but we cannot stand by when a house is on fire to engage in lengthy debates over the methods to be employed in extinguishing the fire. In such a situation we instinctively seize upon and utilize whatever method is most available and offers assurance of speediest success.

Something tells me we may hear more of the name of Steagall, for it was Henry Steagall who helped establish the Federal Deposit Insurance Corporation and it was Henry Steagall who, by means of the Glass-Steagall Act of 1933, helped prohibit bank holding companies from owning other financial companies including the sort of broker-dealers who have helped ignite the current bonfire. Those provisions were repealed in November 1999. They should never have been allowed to. Perhaps Goldman Sachs and Morgan Stanley will survive as newly converted bank holding companies. Whether they do or not, their future earnings prospects look frankly, for want of a better phrase, subprime.

Professor Shiller cites Benjamin Friedman and his 2005 book 'The Moral Consequences of Economic Growth' which suggests that "when people see encouraging prospects for the future, they are better able to work together constructively, supporting democratic principles and political and social liberalization. When perceived prospects for growth falter, there are major setbacks.." In much of the world and particularly in Europe, the Great Depression of the 1930s led in turn to squalid outcomes like fascism, anti-Semitism, racism, nationalism –

and ultimately a world war. But the US, by contrast, "stands out as an exception – in many respects the exception" to Friedman's theory. Now, in 2008, it would truly be a tragedy if the US were to join the rest of the world in a retreat to profitless finger-pointing and mudslinging ***before*** confidence in the financial infrastructure was shored up by government action.

Comparisons with the 1930s are no longer grotesque overreactions. Since there are no private entities with the resources to recapitalise the banks, it will be left to governments and taxpayers to do the job, provided politicians can abandon their differences and finally acknowledge the threat posed by a systemic meltdown in financial confidence. But the US bailout is not a bailout solely for Wall Street interests. As the author behind Accrued Interest makes clear, if bank lending disappears, so in its wake does the housing market; secondary education; small business foundation.. Whether we like it or not, we live in a society largely built and dependent on the free flow of credit.

As to matters of investment, the advice remains what it has always been. Capital preservation trumps 'growth at any cost'. Cash remains king. Fretting about bank stability is missing the point: have any depositors anywhere been allowed to lose one penny of their deposits yet ? The monetary metals still represent a superior store of value than any form of paper. The arguments for government bonds just get louder, notwithstanding the imminence of greater supply. And for those investors with the psychological resources to see beyond the fog of the present, shares in well-run businesses and well-run managed funds are starting to look (and certainly *feel*) compellingly attractive longer term buys. A final note on equity market pricing. If equity prices and the prices of other financial assets go down relative to our incomes or purchasing power, we become ***wealthier*** rather than ***poorer***. This is not meant to be a sophistic argument. The danger would simply be for governments to try and shore up (housing and equity) market values – as opposed to credit availability – at unsustainable levels. So it may not feel like it – human beings are not hard-wired with the contrarian instincts to be successful investors – but we may actually be sitting on the cusp of opportunity. In the interim, nobody ever promised us a rose garden.

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[i]If I had known then, in September 2008, what I know now, in September 2018, I would have felt differently about Congress' "rescue" of the banking system. I would now have more sympathy for the sentiment expressed by Matt Taibbi when he wrote in April 2010 that

> By now, most of us know the major players. As George Bush's last Treasury secretary, former Goldman CEO Henry Paulson was the architect of the bailout, a suspiciously self-serving plan to funnel trillions of Your Dollars to a handful of his old friends on Wall Street. Robert Rubin, Bill Clinton's former Treasury secretary, spent 26 years at Goldman before becoming chairman of Citigroup — which in turn got a $300 billion taxpayer bailout from Paulson. There's John Thain, the asshole chief of Merrill Lynch who bought an $87,000 area rug for his office as his company was imploding; a former Goldman banker, Thain enjoyed a multi-billion-dollar handout from Paulson, who used billions in taxpayer funds to help Bank of America rescue Thain's sorry company. And Robert Steel, the former Goldmanite head of Wachovia, scored himself and his fellow executives $225 million in golden-parachute payments as his bank was self-destructing.

> There's Joshua Bolten, Bush's chief of staff during the bailout, and Mark Patterson, the current Treasury chief of staff, who was a Goldman lobbyist just a year ago, and Ed Liddy, the former Goldman director whom Paulson put in charge of bailed-out insurance giant AIG, which forked over $13 billion to Goldman after Liddy came on board. The heads of the Canadian and Italian national banks are Goldman alums, as is the head of the World Bank, the head of the New York Stock Exchange, the last two heads of the Federal Reserve Bank of New York — which, incidentally, is now in charge of overseeing Goldman — not to mention …
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> But then, any attempt to construct a narrative around all the former Goldmanites in influential positions quickly becomes an absurd and pointless exercise, like trying to make a list of everything. What you need to know is the big picture: If America is circling the drain, Goldman Sachs has found a way to be that drain — an extremely unfortunate loophole in the system of Western democratic capitalism, which never foresaw that in a society governed passively by free markets and free elections, organized greed always defeats disorganized democracy.

In most other respects, I stand by every word written 10 years ago. From an asset allocation perspective, of course, the game has changed. Having been artificially inflated by the forces of QE and ZIRP, bonds are no longer – in our view – remotely investible. But we continue to see merit in the capital growth and portfolio insurance potential of sensibly priced 'value' stocks, uncorrelated funds (especially systematic trend-followers) and precious metals. 10 years on, it seems increasingly likely that governments and their economic agents, the central banks, will respond to any future major crises with the same inflationary impulse, so we continue to see inflation protection (by way of pragmatically chosen real assets) as more important than insurance against outright deflation. Either way, if in doubt: diversify. It now seems abundantly clear that the politicians of 2008 and its aftermath achieved very little from the most aggressive monetary stimulus in history – other than sowing the seeds of political discord that are now starting to germinate with a vengeance. Turns out that pumping a few trillion dollars into the financial markets buys you a bit of time (10 years' worth, and counting), but not much else of practical value.

The commentary is now off on a late summer holiday, and will return in early October.

www.pricevaluepartners.com @timfprice

Tim Price is co-manager of the VT Price Value Portfolio and author of 'Investing through the Looking Glass: a rational guide to irrational financial markets', extracts from which appear in this article. You can access a full archive of these weekly investment commentaries here.

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