Ed ‘N’ Earl

by Doug Wakefield with Ben Hill

> “It took five years for Yevgenia to graduate from the ‘egomaniac without anything to justify it, stubborn and difficult to deal with’ category to ‘persevering, resolute, painstaking and fiercely independent.’”
>
> – Nassim Taleb, The Black Swan: The Impact of the Highly Improbable

I’ll celebrate my 50th birthday this fall. As I look back over the last 5 years, I’m amazed at how many of my views on particular aspects of money, politics, and history have changed. With the added clarity that comes from reading experts in science, general history, financial history, individual and crowd psychology, fundamental and technical analysis, and ethics, my convictions, regarding the world in which I live, have become much stronger than in the 45 years prior to 2002. I’ve come to understand and ponder how our fast-paced, specialist-oriented, self-focused lives have lead us to a point where we view the world as a random collection of dots and noise, never considering how real world events interrelate with real financial and investment decisions.

While the characters presented herein are fictitious, I think you will find their discussion more realistic than many investors and advisors would care to admit.

Ed: Hey Earl, how’s business?

Earl: It’s great. In fact, 2006 was one of my best ever. How about yours?

Ed: Great year. Great year.

Earl: Are you still as concerned about the financial markets as you were a couple of years ago?

Ed: Actually, I’m even more concerned now than I was then.

Earl: Frankly, Ed. I think you spend too much time trying to figure this all out. Don’t you think if there was a Holy Grail, that someone would have found it by now?

Ed: You’ve got that right; what I’ve read and experienced over the last few years has convinced me, more than ever, that there’s no Holy Grail. Still, there are a lot of things in the world around us that I think have made our financial markets riskier today than they were a few years ago.

Earl: Maybe so, but with information at our fingertips 24/7, there’s no way that any *one* investor’s any smarter than the rest of the players in the market. Besides, I just read a recent study by Standard and Poor’s on market tops. Their chief technical strategist said that “pretty much anyone who invested in the S&P 500 at

any point in time is now sitting on a profit, assuming that person sat through the entire period."

Ed: Yeah, I saw that article. Did you notice that the author of the article also said that "the profit would be minimal for an investor who bought an index fund after the previous closing high in March 2000, as the S&P 500 today stands a few points above that point."

Earl: Well, I suppose you can always find some sort of exception if you look for it.

Ed: But, Earl, let me ask you something, "If you were one of the most heavily marketed brands in the investing arena, wouldn't it make sense that your 'research' might be a little biased?

Earl: What's your point? You're just mad because your trading managers under-performed my indexers again last year.

Ed: Look. I agree that if you under-perform the Dow on the way up, hiring managers with decades of experience is seen as worthless. But, a study of history shows that, in deep bear markets, not having an exit strategy can be very costly to clients' investments and to our businesses. And, neither one of us has to look any further than 2000 to 2002 to prove that.

So while the Dow may seems disconnected from real world events like housing prices, retail sales, the War on Terror, or global events, I believe that the amount of debt that we're carrying as individuals, corporations, and government entities, will have a significant impact on our economy.

Earl: If you keep going with that old fashioned view of debt, you'll never understand why our companies and markets can continue to climb for years.

Ed: Alright, I'm all ears; let's here your theory.

Earl: I just read a great article by Ken Fisher called Learning to Love Debt. As you know Fisher is a billionaire and his firm manages over $30 billion in assets.

Ed: Yeah, I'm familiar with Ken Fisher. Go ahead.

Earl: Well, Fisher stated that based on his calculations, he believes that if we tripled our debt levels, we'd be closer to profit maximization and increase the amount of wealth in our society. And, hey, think about it Ed, we could triple our assets under management!

Ed: The only problem with what you or Mr. Fisher said is that I can't find any historical evidence that shows that individuals, companies, or nations that continue to increase their debt levels are helping their long-term health. In fact, the more money, which today is a euphemism for debt, that comes into an economy, where yesterday's debt is paid off with tomorrow's larger debt, the more societies come to believe that inflation is always a good thing. But, the historical record proves otherwise. Have you ever read Dr. Murray Rothbard's America's Great Depression?

Earl: There you go again; I guess, once a naysayer always a naysayer.

Ed: Hey, I just thought that the way we're supposed to avoid problems in the future is to learn from the past. While you're at it, you might want to read Bailout: An Insider's Account of Bank Failures and Rescues by Irvine Sprague or James Grant's Money of the Mind.

Earl: Have those books been written in the last few years?

Ed: Nope, Irvine Sprague's book was written in 1986 and Jim Grant's was written in 1992. Keep in mind, Sprague was an FDIC Chairman and Director who supervised banks from the federal level for 18 years, and Grant's been writing about debt and debt instruments in his newsletter, Grant's Interest Rate Observer, since 1983. Doesn't it sound like these guys might know something that we don't?

Earl: Look, I can find plenty of old timers who are bullish, and you can find plenty of old timers who are bearish. I don't see your point.

Ed: My point is this: You just stated that if debt could triple, since there'd be a lot of people looking to place that money in something, that you could triple your

assets under management. Actually, debt's been growing for decades, especially since we came off the gold exchange standard in 1971.

Earl: Here you go again with that gold bug stuff.

Ed: Look, that was just a statement about history, not the price of gold. But if you don't want to look at history, let's look at somebody else who'd disagree.

Earl: And what investment guru is that?

Ed: Well he's not an investment guru, but his involvement in politics has certainly influenced a lot of the high level financial decisions of our government. I'm talking about Brzezinski, National Security Advisor to the Carter Administration. In his new book, Second Chance: Three Presidents and the Crisis of American Superpower, which just came out this March, he said the following about America's debt and deficits:

> "Given America's growing global indebtedness (it now borrows some 80 percent of the world's savings) and huge deficits, a major financial crisis, especially in an atmosphere of emotionally charged and globally pervasive anti-American feeling, could have dire consequences for America's well-being and security. The euro is becoming a serious rival to the dollar and there is talk of an Asian counterpart to both. A hostile Asia and self-absorbed Europe could at some point become less inclined to continue financing the U.S. debt."

Earl: Listen. I agree that some of what Fisher said sounds a little out there, but we're not about to face any serious market crash anytime soon. I mean, the markets are going up, my clients are happy, I'm bringing in more business, and besides, we've always had these kinds of concerns, and if it did happen, we have learned lessons from 1987 and 2000 to 2002 that would help us today.

Ed: Let me ask you something, Earl. In 2000, did you tell your clients that they should brace themselves for a 50 percent decline in the S&P 500?

Earl: Alright. I get your point. But I still say nobody really knows what's going to happen tomorrow. And, for that reason it's safer to buy and hold that to try to guess when the stock market's going to go up or down.

Ed: Then, I'll leave you with this. One of the newsletters I read is by a guy named Gregory Weldon. He looks at money, or credit growth, around the world every week. Some of the numbers he's been presenting are pretty alarming. Now, I know we have been taught not to use words like "alarming," but that word seems to fit. This week, he pointed out that the Fed's most recent report on US Commercial Banks, revealed that bank credit *increased* by $34 billion in a single week at the same time that deposits *contracted* by $68 billion. With the fact that

debt has risen right along with asset prices, is debt really as benign as the "research" you presented to me earlier suggests?

Weldon also pointed out that, according to the Fed, there's been a substantial decline in the growth of mortgage debt. In the 3rd quarter of 2005 it grew at 14.8 percent; in the 2nd quarter of 2006 it grew at 9.5 percent. Now, in the first quarter of 2007, it only grew at 6.2 percent. Paul Kasriel, of Northern Trust, says that the Fed's own models suggest that housing is overvalued. How can so many investors and advisors believe that the markets are efficient, and that no one should ever try to "time the market," or sell, at the same time that the Federal Reserve's models suggest that housing is overvalued?

Earl: Look, we may have a few bumps in the road, but in the long term, my business and my investors are in a good position. We're well diversified; we don't need to worry about all this stuff.

Ed: Alright. I know this conversation hasn't been very pleasant. But, after living through the crash of '87, the recession of 1990, the hard decline of the markets during Long-Term Capital's collapse in 1998, and the crash of 2000 to 2002, I went back and thoroughly studied each of those events to see what caused those declines. Based on my experiences over the last few years, I can assure you that the majority of individuals and institutions out there today *still* do not study history. Even though, at the time they'll probably see us as naysayers or just plain stubborn, this is where we can provide the best service to investors. As markets change, so also will peoples' attitudes.

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Best Minds Inc, A Registered Investment Advisor

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