

A Tsar Too Far

Not that anyone at RCB would need it, but upon the suggestion of a “friend,” I recently read (ok, re-read) Dr. Bob Rotella’s book, *Golf is Not a Game of Perfect*. Among the variety of frighteningly applicable lessons (to our friend) was the idea that many golfers continually beat themselves up over poor shots, yet when the 195 yard five iron to within two feet of the pin materializes out of nowhere, there is the tendency for the player to write that off as a “fluke,” or “lucky” or a disdainful “finally.” But again, I am merely passing on second hand information.

Rotella’s point is that the golfer will play better and score lower if he applies a superior mental game that equally weights an internal “attaboy” associated with a good shot, with the attendant depression, sullenness, club throwing and “colorful” language that often accompanies a poor shot, a series of poor shots, a series of poor holes or sometimes even an entire summer of rounds.

It is in this light, our friend suggested, that we should view the last two years in the financial world and thus take some reasonable sense of satisfaction in the very good to the off-the-chart numbers we are putting up this year. Rotella’s suggestion of

symmetrical pain and joy manifests itself in our investment strategy in a somewhat contrary way. Our investment process seeks to avoid getting mentally distraught in a terrible down draft and thus maintain the discipline to put money to work, while on the other side of the spectrum, we increase our humbleness and caution in the midst of overwhelming short-term success. Investing becomes a series of painful beatings if you do not understand that equity returns in the long run exhibit negative serial correlation – exceptionally poor recent returns greatly increases the probability of putting up subsequently excellent numbers and vice versa. That’s Andrew Smithers’ (great new and serious book: *Wall Street –Imperfect Markets and Inept Central Bankers*) way of saying buy low and sell high around a 100 year slope with a 6% incline after

inflation. We stood tall-ish last year and early this year, and have benefited greatly from the teachings of the great investor Woody Allen, who noted that 80% of success is just showing up.

Going forward, we will paraphrase Warren Buffet’s old line, “economic and stock market forecasts tell more about the forecaster than the economy or the stock market.” Those who have been persistently bearish and missed the entire rally remain persistently bearish on the familiar litany of global issues: the consumer remains over-levered; the housing and credit markets only appear to be making bottoms because the government continues to medicate them with hundreds of

billions of freshly printed dollars; the economic recovery, if it is here at all, will take the shape of any letter in the alphabet that isn’t V; China and other emerging markets are their own bubbles and are not sustainable growth engines for the world economy; and we will be grinding along like Japan for a lost decade. Or, you are simply aghast at what is currently passing for economic debate, mortally afraid that we are debasing our currency with clear and obvious inflationary policy.



“My stocks are all going up again. Is that a bad sign?”

Source: CartoonBank.com

And yet here is what is endlessly sublime about financial markets. Why is it that the bears always seem to have better, more detailed and cogent arguments, yet the number of successful and dedicated short sellers can probably be counted in the single digits? Now, making \$3 billion in a year shorting the mortgage and financial world (and you know who you are) would tend to negate the argument that “success” is defined as having some kind of a longer-term track record. But having waded through yards of PowerPoint over a number of economic and market cycles over 25 years (and our own Jim Reed backs me up with data from the 1920s) with every graphic detail of how we are going to straight into the toilet, somehow life manages to muddle on and the stock market’s long-term trend line remains 6% in real terms. The value of

plowing through the Smithers' book is just how much historical data hammers this home. If you buy below fair value, you will earn higher than 6% annualized after inflation. If you lean against the wind and sell into material overvaluation, you can also improve your return. If you do the opposite, you will likely wind up in Congress or as a regular on CNBC.

And thus the bullish argument from this spring which has morphed into more of a "just not so negative" argument now is oddly Mr. Rogers-like and reflects the enduring mystery of capitalism and financial markets, which of course maddens elected officials and those who are doomed to a process that is laser focused on the scientific analysis of the recent past and its linear projection into the future. The ugly "facts" of what has transpired over the past few years are well known, and reasonably well discounted into pricing in financial markets – and while many of them will likely continue to weigh on our productive economy for sometime, they weigh less every quarter as opposing forces – and buyers – create bottoms from which new trends begin. The things that one should worry about are likely not what is in the newspapers EVERY single day and currently being debated by Congress. (They are out there, but neither you nor I are likely to be on an email list.) There remains an oppressive level of caution, and "yeah but," which is a massive version of the proverbial wall of worry for the market to climb. *Time* magazine, whose cover stories are a legendary counter cyclical event, weighed in this month with a sinking ship of 401k's, as if declaring 30% returns in the market this year are not enough or not to be trusted.

Save that of World War II, in the last two centuries we have not witnessed anything like the massive scale of elected officials (and the un-elected in China) pouring resources into the global economy, all of which may have unpleasant consequences for decades, but it clearly puts gas in the tank of an economic recovery. I would also argue that a number of financial institutions are quietly becoming over capitalized through regulatory fiat as well as massive earnings leverage from the yield curve, the latter of which rarely fails as a leading indicator of future economic growth. While stocks have correctly predicted eight out of the last two recessions, when they have rallied out of a recession, they have not failed as an indicator of positive growth.

As we noted in our last Strategy Letter, "we need definitive economic growth from here in order for the equity markets to generate decent returns." Well, how much? We rely on our friends at the Applied Finance Group for some stats. Using 17 year averages for cash-flow margins and Asset Efficiency ratios for the S&P 500, (Why 17, we also asked? Answer – it encompasses 3 recessions and peaks and that's as far back as they went) the market appears to be pricing in less than 6% nominal sales growth for the S&P for the next five years. That is below the highly suspect 9% average sales growth number for the last 17 years, and seems to confirm our bottom-up research that many stocks have simply swung from ridiculous to something approaching normal.

There appears to be many who are obsessed with percentage changes, without regard to the actual level of the numbers. The move in the stock market in 2009 is simply reflective of the depth and pain of the move last year and is not necessarily a reason to fret that stocks have come too far too fast. Could there be an imminent 10% correction? Of course. But who knows and how much does that really matter unless you are funding a one-year liability and in that case how much should you be in stocks anyway? Our recent meetings with a global set of advisors and their clients suggests there is an enormous amount of fretting and handwringing over "missing" the rally, the result being further paralysis, which is as counterproductive as aggressively reducing your "risk" exposure at the bottom of the market.

We would suggest investors would be entirely better off with recognizing that long-term equity returns have been remarkably consistent around the 6% real rate and that is the highest likelihood of what they will look like over the next five to ten years starting from the current base of reasonable fair value. This suggests to us a traditional approach of patient and carefully researched value investing is as timely today as it has been throughout the vagaries of history. Our portfolios remain a mix of offensive and defensive names in regard to the economic outlook and reflect our assessment of the best combination of business quality, valuation and management that we can assemble within our sphere of competence. Same as it ever was.

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The song that also remains the same is the current nonsense flowing about in enormous quantity in regard to executive compensation in general and the financial services industry specifically and the related debate on how the financial services industry should be regulated in a well meaning attempt on how to prevent another financial crisis.

Starting with the forest before the trees, what seems to be missing in the current debate is that financial crises' derived from the folly of men and bankers are literally thousands of years old. Moving somewhat forward in history, banks and bankers have blown themselves up with stupefying regularity in this country before and after there was a Federal Reserve, SEC, FDIC, derivatives, pay option mortgages, stock options, Glass-Steagall and the repeal of Glass-Steagall, and Sarbanes-Oxley. To suggest that a trinity of lawyers, academics and politicians of any stripe is going to "fix things" so that financial crises are things of the past, is simply the height of inanity.

We also seem to forget that 12 months ago, the world salivated for the normalization of the financial system and its attendant profits. With near zero short-term interest rates to finance assets; the alphabet soup of ideas trotted out by the Treasury and the Federal Reserve in order to stimulate liquidity and encourage distressed security investing; a massive amount of refinancing via new issues of stocks and corporate bonds, and huge and welcome rallies across all asset classes across the

globe, what exactly did people in Washington think was going to happen to the profits of financial institutions that were still in business? Shouldn't congressmen and regulators be slapping themselves on the back for a job well done? And if pay is tied to performance, where it is on Wall Street like it is nowhere else in the world, does it not make sense that compensation will be a heck of a lot higher this year?

The other forest-like issue in executive compensation is not at all specific to the financial services industry. Executive compensation as generally practiced in America, remains a general travesty and an asymmetrical mess as stock options continue to be handed out like candy for little reason other than someone shows up and gets to park in the CEO spot. The ground-breaking move toward the rewarding of restricted stock in place of stock options in some cases is a net zero improvement as an incentive since it once again is often handed out for nothing but showing up. Its only benefit is that senior management does not have to get dragged into a discussion over Black-Scholes option valuation and how it is accounted for in earnings. Both measures can be effective means of incentive compensation if there is some sort of economic hurdle for earning them, but that is a rare instance and where there are hurdles, they seemed designed for a pygmy sized track and field team. And while having a management team that is oblivious to the price of their stock is one extreme, we have obviously witnessed the other extreme – rewards being earned for nothing but showing up in a bull market, and to be fair, zero rewards being earned for good operating performance that might not be reflected in a stock market that gets shellacked.

This state of affairs is a complex and ugly brew and it is the result of laziness, innate human behavior that does not reward confrontation, the institutionalization of established poor boardroom practices, massive indexation by massive pools of money that allows outsourced proxy voting which allows poor practices to continue in near anonymity, and of course a corporate governance system that makes it difficult for the few shareholders who even bother to actually effect change. What is clearly not going to produce material change for the good is the appointment of "Pay Tsars," the fomenting of class warfare by elected officials and the intrusion of government into several hundred years of the legal development of private contract law.

The employees of both Bear Stearns and Lehman Brothers owned nearly 30% of their own stock, a true testament to the fact that no legislation will ever prevent aggressive stupidity and hubris from standing in the way of spectacular human failure. As noted in a *Business Week* article years ago touting Lehman Brothers and its CEO, "One of Fuld's goals was to build insider ownership of Lehman stock and align the interests of employees with shareholders. In that, he's succeeded. Lehman's managing directors get paid about 30% of their bonuses in restricted stock with the price set at a 30% discount to the market. Through this and other stock-ownership programs, Lehman's employees now own about 25% of the company's 125 million shares. Fuld's holdings are

worth over \$100 million." (Fuld eventually lost about \$1 billion in stock value from top to bottom.)

While we once again hate to be in the position of justifying Goldman Sachs to the world, we would note that the poster child of the Pay Tsar world pays out nearly 50% of its profits to its employees (a poster child for a unionized company we would think) and two-thirds of its bonuses are paid out in restricted stock that vests over four years.

A recent study by professors Rene Stulz and Rudiger Falhnenbrach at Ohio State University (<http://www.cob.ohio-state.edu/fin/faculty/stulz/>) sheds some light on the issues of financial service compensation and the financial crisis and it is interesting enough to reprint almost verbatim. "There is no evidence that banks with CEOs whose incentives were better aligned with the interests of their shareholders performed better during the crisis and some evidence that these banks actually performed worse both in terms of stock returns and in terms of accounting return on equity. Further, option compensation did not have an adverse impact on bank performance during the crisis. Bank CEOs did not reduce their holdings of shares in anticipation of the crisis or during the crisis; further, there is no evidence that they hedged their equity exposure. Consequently, they suffered extremely large wealth losses as a result of the crisis." That seems fair, doesn't it?

Jamie Dimon of JP Morgan owns over \$100 million of JP Morgan stock. Why didn't JPM stuff itself with alphabet soup nonsense assets when Merrill, Lehman, Bear Stearns and Citibank did? Can Jamie Dimon's DNA be legislated? Is it a stretch to suggest that attempting to severely regulate pay is as tiresome and thankless a task as designing healthcare regulation?

Is our country better off in a system where the management of our largest and sometimes most successful companies (correlation unclear) are contemplating how their actions might play in a Congressional hearing or the Op-Ed page versus long-term profit maximization? Does anyone want to own stock in that company much less work for it? And I am speaking here as a taxpayer/shareholder who cannot help but cringe at the spectacle of Citibank being forced to sell its Phibro trading arm for essentially cash value to Occidental Petroleum because it is embarrassing to have to pay a contractual and well earned \$100 million to its leading principal? We, the people, are now giving up an estimated \$200mm in annualized profits in an institution that can sure use it. (And yes, Occidental has been moved up to the warming plate of potential RCB investments.)

The concept of "fairness" is a morally and politically tortured concept and has historically been a sporting proposition for the media and elected officials and I have no doubt this will be a truism 100 years from now. So when Barney Frank is quoted in a recent *New Yorker* article saying, "I believe that too much money goes to these people. I think there is in economic terms, a rent is being paid that exceeds what is needed for

their efficient performance,” is he referring to the financial services industry or Alex Rodriguez, who gets \$166,000 a baseball game when the average minor leaguer gets \$1,100 a month? (Ok, he’s worth it this month.) Is anything fair for the NY Mets ticket holder whose per game cost has to pay for the second highest salary base in baseball and a 70-92 record, not to mention \$12 beers in plastic cups? What does the Key Grip make in yet another awful film where fill in the blank gets \$18 million a picture? How can Madonna, Lady Gaga or Beyoncé put out the same tired, over-produced pop dance nonsense and get paid hundreds of times what the head violinist for the LA Orchestra is paid? Is it possible that it is more than 15 times (a bizarre, plucked out of thin air number that is often bandied about as a suggestion of the proper ratio of highest paid to lowest paid in a company) harder to invest in the financial markets in a way that can generate a \$300mm profit than it is to make change at a teller window? The answer that has served this country well for a few hundred years is that “this is private business between consenting adults and it’s none of your business as long as it’s legal and taxes are being paid.”

It has been argued that since the taxpayer “bailed out” these financial institutions, the taxpayer with the Federal government as the agent should be restricting the pay of the executives of these institutions until the money is paid back. Ignoring for a moment prior arguments we have made about government officials literally extorting the executives of privately-held financial institutions to take public money and the utter miscalculation that many bank executives made in subsequently taking TARP money in order to appear among the “chosen,” if one were simply a bondholder concerned with simply getting his money back without regard for the target being a viable going concern, then bleeding TARP banks would be the correct attitude. In fact, many aggressive bondholders actively try to push companies into bankruptcy in order to lay claims to corporate assets as a simple mathematical judgment. But with the real exception being parts of the AIG structure, we the taxpayers are almost exclusively equity, warrant or convertible preferred holders and thus it is NOT in our financial best interest to bleed our holdings and destroy the goodwill of a business franchise. And just to take a popular political argument, if one’s desire is to maintain a healthy and diverse financial system that is not overly concentrated into an uncompetitive small group of “Too Big to Fail” (TBTF) institutions, then you must allow Boards, management and shareholders to operate relatively unfettered.

There are plenty of intelligent things that our elected officials can influence in order to improve our financial system. As is often the case, simple would work better than 1200 pages voted upon in the wee hours of the morning. Ridding the markets of what originated with the “Greenspan Put” and now marauds under the TBTF doctrine would be first on any list. Cutting interest rates to near zero on the first hint of an economic downturn and then holding them there for excessive periods has been a key enabler of the ability of perfectly rational people to make irrationally larger and larger mistakes that do threaten a core stability of the financial system.

The most basic reform involves depositor’s insurance. With the exception of foolish monetary policy, eliminating the necessity of consumers, businesses and investors of having to make even the smallest attempt to discern the quality of the place they are putting their money has enabled legions of poor credit decisions. From Fannie Mae to the brewing debacle of the FHA, misplaced and mispriced government guarantees, implicit or explicit, have also created odd distortions that enable the use of more leverage that raises the penalties for mistakes geometrically. It is utterly appropriate to demand higher capital ratios and a higher level of regulation for institutions that rely on federally guaranteed deposits and these higher capital ratios in and of themselves will likely reduce profitability and limit egregious speculative behavior and the bonuses derived from it.

Is it also wrong to ask that the huge number of existing regulatory agencies be refocused and retooled to actually work together in an effective fashion as opposed to creating new forms of bureaucracy, our favorite being the proposed Consumer Financial Protection Agency? Every trial balloon out of this particular piece of nonsense is busy tightening credit in the marketplace as we speak to those who can least afford it. And if there is a worse idea than allowing states to trump federal financial regulations and enforce their own rules and regulations, I have not heard it.

Getting most forms of derivative trading on an exchange, which enables transparent clearing, will eliminate much of the counterparty fears that plagued the world last fall and be a major positive force for increased financial stability.

Lastly, what can truly be done to inspire Boards of Directors to stand up to the current banality of executive compensation practices and effect measures like measurable and transparent economic hurdles for option and stock issuance and limit conflicts inherent in golden parachutes and non-economically based bonus guarantees? What can be done to get shareholders to actually read their proxy statements and not outsource their oversight to possibly conflicted and political third parties? Is it possible to outlaw or discourage any of the garden variety of financial foibles – greed, ignorance, stupidity – that have afflicted investors for hundreds of years? Is it possible that someone or some organized body can help the investor from sometimes simply being massively wrong and blindsided by a giantly incorrect view of the world? I doubt it.

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