Thirty Years of Investing from the Cheap Seats

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At the end of each calendar year I evaluate the year-over-year change in my financial status. It is all too easy to focus on pockets of good (or bad) news and lose sight of the big picture. The centerpiece of the analysis is how much my total personal wealth—the sum of investment and savings—has changed. As my 30th year of investing came to a close it seemed like an opportune time to take a serious retrospective gander. This is of growing importance because over the last dozen years I have shifted from a generic fiscal conservative to a libertarian devotee of Austrian economics. I *must* assess whether these views are helping or hurting. This is a highly personal account of my efforts to get to a worry-free retirement; some would argue a little too personal for polite company. The details are necessary, however, to tell the story of a work in progress that is both a success to date and very risky going forward.

My investing philosophy is a little offbeat when compared to conventional wisdom. I rarely enter a short-term trade, but do not buy-and-hold broad market indices nor diversify for the sake of diversifying. (I would no sooner knowingly let AMD sneak into my portfolio than willingly eat liver from a buffet table.) Secular bull markets take several years to start, years to run their course, and do not appear in all asset classes concurrently. The trick is to spot those rare secular changes and then, many years later, somehow know when to exit. Really exceptional ideas—those rare opportunities to make serious gains—appear occasionally, but acting on them can be a lonely experience loaded with self doubts; I often take several years to acquire a full position. Exits, although usually incremental, are highly compressed into a few months and likely to be permanent. I currently have only two ideas that I believe were great at their inception and remain credible; one or two more would be appreciated.

1955-80: The Formative Years

My Dad was a contractor and a brilliant ground-level economist. This guy knew business from the bottom up—soup to nuts. We discussed economics, business, politics, and ethics at the dinner table. I can vividly remember talking about merit-based pay, survival in boom-bust cycles (which are common in construction), investing in distressed assets, barriers to entry in business, creative destruction, the evils of unproductive debt, and, of course, big-government inflation (which deserves hyphenation). As a kid I aspired to go to Wall Street, but the stagflationary 1970s had its toll, and I became an organic chemist instead. The critical message, however, is clear: talk to your kids because they might listen.

1980-87: Nothing But Bonds

I started my career as an assistant professor at Cornell with no assets, no debt, a relatively modest salary, and no personal life; times were good. I was far too busy to care about retirement. With interest rates at nosebleed levels and a dismal multi-year performance of equities—a subtle hint that might have caught my eye in later years—I allocated *all* retirement contributions to bonds and fixed income via TIAA and then paid no attention whatsoever for seven years. Nobody knew at the time that building wealth via stocks or bonds over the next two decades would be like pouring water out of a boot with the directions on the heel. Of course, equities beat bonds in the early 1980s, but by a much smaller margin than those who traffic in equities wish to admit. The early 1980s were the "salad days" of the secular bond bull. With a new house, however, my savings could have been better.

1987-98: Birth of an Equity Bull

Ironically, it was the Crash of 1987 that prompted me to move into equities. The bulls were desperately making their case that the crash offered a buying opportunity, and I bit. (The equity bulls were a brighter bunch in those days.) I redirected all savings and retirement contributions into equity index funds, but then resumed paying no attention for another ten years. In January, 1995 I had a fateful lunch with a friend. This guy was a travelling salesman. He visited hundreds of chemical and biotech companies per year and would take management to lunch to discuss their business and talk stocks. The more he knew, the more he could pry loose from his lunch guests. The guy was a conduit of information—a stock gossip—and his stories were compelling. He talked me into placing some bets: Warner Lambert had this promising drug called Lipitor; Minimed had a very cool insulin pump; LDDS, a small company in Mississippi, had a killer acquisition strategy that would years later metastasize into Worldcom. I independently stumbled into an emerging computer company (Dell) and a Norwegian bottle recycling company called Tomra. (It was a great Peter Lynch play; the only research was in Norwegian, but Tomra eventually became one of Merrill Lynch's European favorites.) Although the gains in absolute dollars of my individual stock picks were small—they were side bets in a rapidly appreciating SEP-IRA—the percentage gains were intoxicatingly huge. The bull market made us all look like heroes, and I was Spartacus. While I was doing victory laps, contrarians began to notice that the greatest fools had entered the market.

1998-2000: Y2K and the Birth of an Equity Bear and Gold Bug

I had a second fateful lunch with the founder and head of Goldman Sachs' software group who happened to be my college classmate and fraternity brother. While picking his brain for software companies that might profit handsomely doing Y2K remediation, he noted that any company not already remediating was probably in trouble. Despite his nonchalance, I flinched: "You are telling me that the computers could go nuts all at one time and some companies are past the failsafe point? Wow." I began a risk analysis of a computer glitch that soon morphed into a broadly based effort to understand connections and interdependencies—counterparty risks if you will—across the globe. With the liberating aid of the internet, I networked with techies, economists, money managers, and pretty much anybody who might bring information to the table (going so far as contacting the chairman of the electrical engineering society's Y2K committee). The Prophets of Doom were telling a compelling story, but there were also serious concerns being expressed by learned people: What would a disruption in goods and services do to an increasingly frothy market? The sleepless nights began in June of 1998, and in July I liquidated half of my mutual funds on the eve of what became known as the Asian flu. It was a bittersweet few months: half of my wealth thrived in total safety whereas the other half got brutalized. By early 1999, the market had recovered, and I liquidated the remaining mutual funds and all equities—*100% cash*. Letting go of the likes of Dell, Worldcom, and other high fliers that had been so profitable certainly tested my resolve. Then I really went to the Dark Side and started buying gold and silver via the Central Fund of Canada (CEF) and shorting the market via the Prudent Bear Fund (BEARX). Society partied like it was 1999 (because it was) while I hunkered down in a financial bunker with moral support provided by a very small cadre of like-minded wing nuts.

2000-2009: The Decade of Hard Assets

Well, 01/01/00 arrived without a hitch. That is a big one for the loss column. The public humiliation began at 12:01 AM with a phone call from drunken revelers and continues sporatically to this day. But as Jack Nicholson said in *One Flew Over the Cuckoo's Nest* after failing to rip a sink out of the floor, "At least I tried!" I also remain convinced to this day that many of the earliest bears—the guys who positioned themselves to weather turbulent markets over the ensuing decade—owe their abstinence to the sobering look at markets prompted by Y2K concerns. We had removed the rose-colored glasses and found ourselves staring into the abyss.

It was now spring of 2000, the imbalances remained, and the markets looked frothier than at any time since the legendary bubbles of the early 18th century. Long before Nouriel Roubini, Peter Schiff, and Meredith Whitney became household names, bears like Bill Fleckenstein, David Tice, James Grant, Doug Noland, Robert Shiller, and Bill Bonner placed their bets and held their ground: the insanity couldn't last. I white knuckled the cash, precious metals, and BEARX. Few can imagine how hard this was. Figure 1 shows the relative returns from the Nasdaq and CEF over a mere five month period. How contrarian—how certifiably nuts—do you have to be to hold gold and shorts while staring at this disparity? But there was another chart that I hung my hopes on; the DOW-Gold ratio (Figure 2) spoke volumes and still does even to this day. The previous peaks in 1929 and 1966 preceded devastating equity bear markets. The ratio *had* to come down at some point.

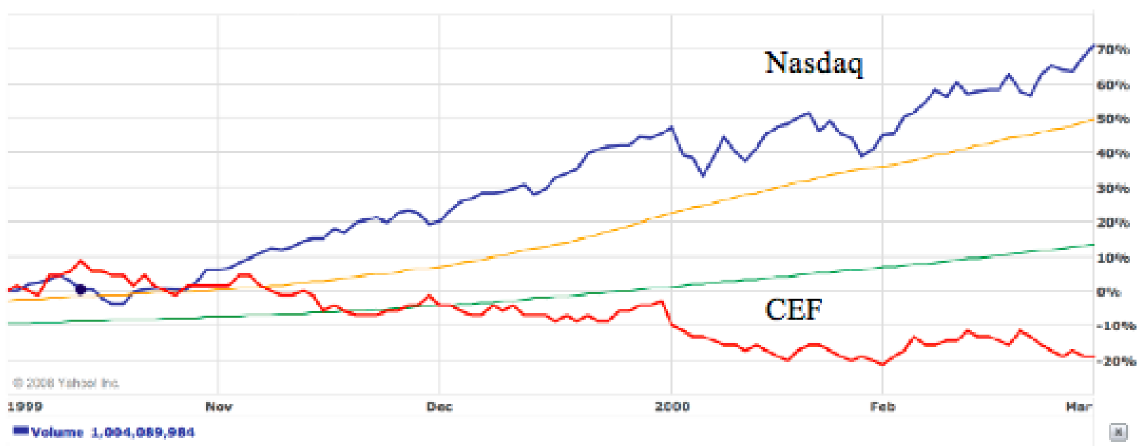

Figure 1. A plot of the NASDAQ versus Central Fund of Canada: 10/99-3/00.

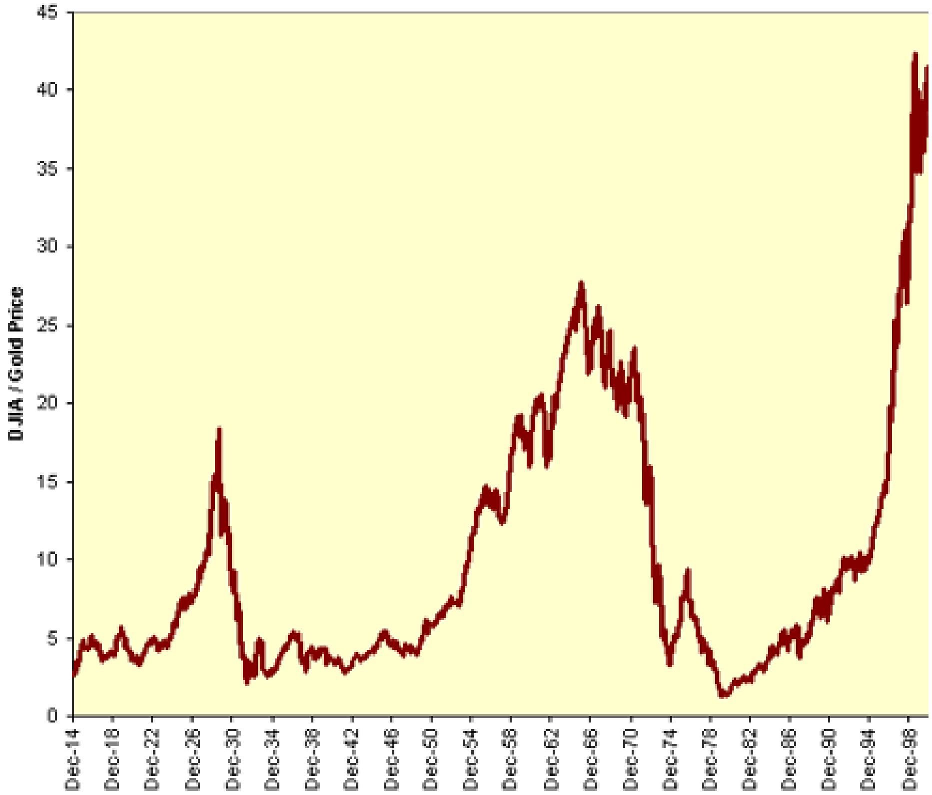

Figure 2. DOW-Gold ratio from 1914-1999.

Of course, the fever finally broke in March, the tech wreck began in earnest, and the eyeball-counting, earnings-oblivious equity bulls were finally shown to be as clueless as some of us suspected. Gold waited a year before bottoming at $256 per ounce. I eventually liquidated the BEARX for a 40% gain but have been accumulating gold to this day.

As the 2000-2002 recession raged and interest rates collapsed, decisions had to be made. I certainly could not coast the last two decades to retirement in cash. How about real estate? I remember in 2001 when octogenarian John Neff recommended Horton Homes. “Are you crazy?” Nevertheless, by 2002 the housing bubble was being actively discussed on the blogs. (James Grant wrote about the excess as early as 2001.) The housing market was way too rich for me. I began, however, to fear inflation in earnest and tried unsuccessfully to buy commodities 2001. Calls to brokerages revealed that white-bread commodity-based investments were simply not available. Following a long and remarkably interesting discussion with Clyde Harrison at the Rogers Raw Materials Fund and another with one of its few market makers, I got cold feet; a fund based on commodity futures seemed too sketchy. (The fund subsequently froze solid as a result of the highly suspicious Refco bankruptcy.) I compromised in late 2001 by moving into hard-asset-based equity funds (energy and precious metal equities) via my employer-based Fidelity retirement fund. I also was drawn to tobacco stocks. (Smokers are very resilient consumers, the 8-12% dividends looked great, and I suspected that the horrible sentiment preceding the gazillion dollar lawsuit was unfounded.)

Those betting on energy and precious metals have been compensated handsomely. The awful timing of my equity sales and precious metal purchases underscored starkly in Figure 1 does not seem so terrible a decade later (Figure 3). The energy and precious metal equities, although disquieting at times, also have worked well (Figure 4).

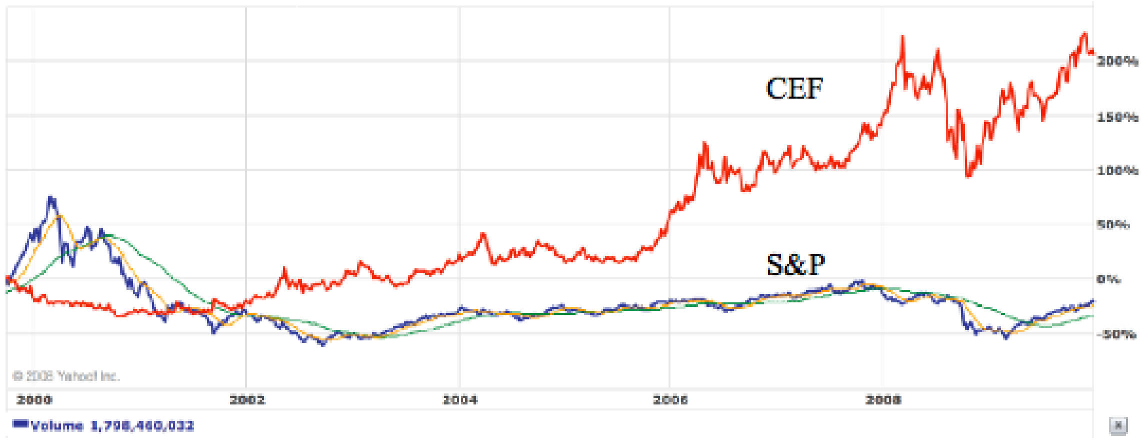

Figure 3. A plot of the NASDAQ versus Central Fund of Canada: 1999-2009

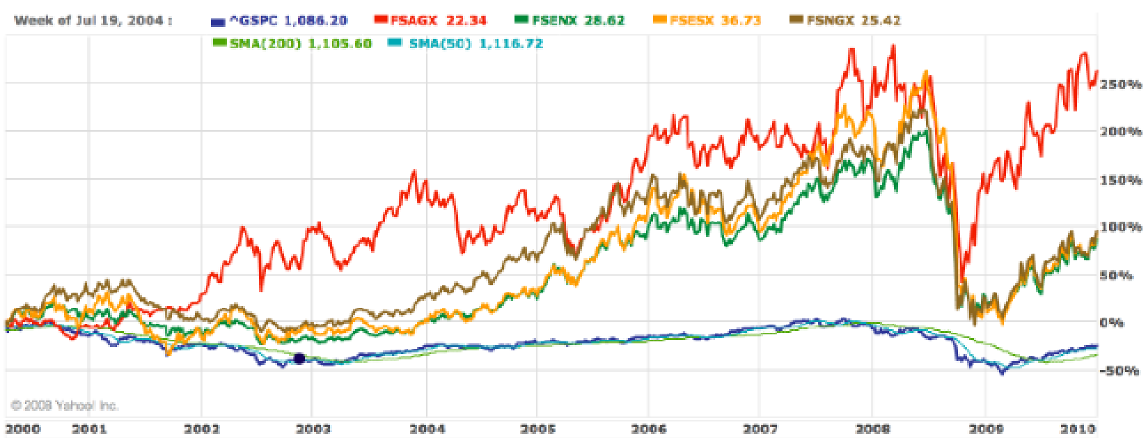

Figure 4. Fidelity hard-asset-based equity funds (precious metals in red and energies in yellow, green and brown) versus the S&P 500 (in blue) from 2001-2009.

(cont.)

So now we finally direct our attention on 2009. For all its turbulence, 2009 proved to be an excellent year for investors who simply tied themselves to the mast and hung on. I entered the year with the following weightings:

cash equivalents:	33%
precious metals/CEF:	45%
energy equities:	15%
Other:	6%

Strong returns in gold (24%), silver (49%), Fidelity's energy and natural resource funds (47-78%), and Fidelity's precious metal fund (38%) (Figures 5 and 6) offset the 0% return on cash to produce a 21% overall return. Precious metals were very strong with spot gold putting up positive numbers for the ninth straight year. (The precious metal bears say they are too volatile. They probably will be volatile some day.) Add a couple hundred basis points due to savings of 18% of my gross income (sounds authoritative to call them "basis points", eh?) , and it really starts adding up. I always swore that if the market really tanked, I would extend my energy position aggressively. The opportunity knocked, but I was too busy hanging on to the mast. I did, however, buy a few tobacco stocks.

Figure 5. Fidelity hard-asset-based equity funds (precious metals in red and energies in yellow, green and brown) versus the S&P 500 (in blue): 2009.

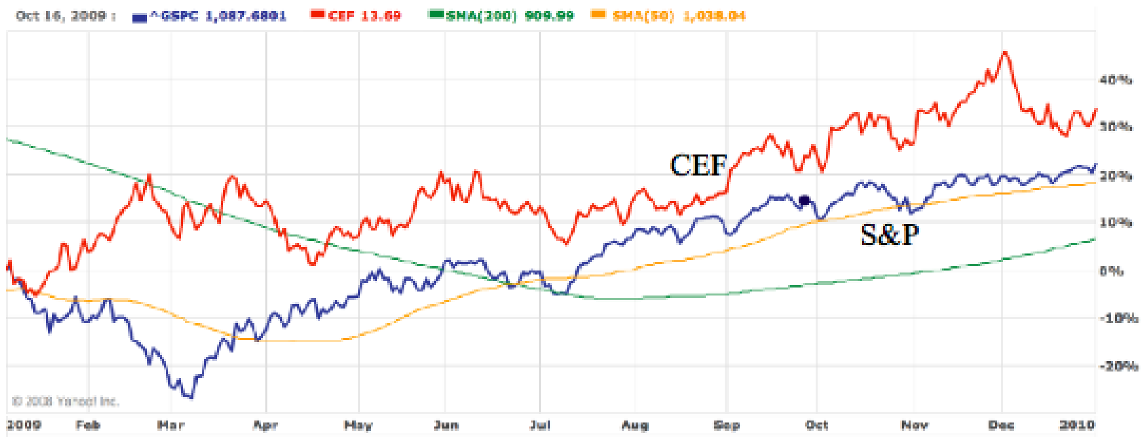

Figure 6. A plot of the S&P 500 versus Central Fund of Canada: 2009

Alas, 2009 is not that relevant because there is nothing normal about it. In fact, I am not sure the markets are ever normal. The 2000-2009 decade was particularly aberrant, however, with the S&P proffering negative nominal returns for the first time since the 1930s. The legendary Bill Miller and his string of victories over the S&P for a dozen years gave most of it back in 2008. Berkshire-Hathaway was a standout, returning just under 7% annualized over the same decade. By comparison, my risk-averse, hard-asset-rich portfolio provided a 10% annualized return on investment.

1980-2009: Total Wealth Accumulation

I opened this essay with the assertion that rising total personal wealth is the key benchmark of progress. It is time to do my 30-year wealth examination. We begin by defining several quantities:

Total Net Worth-I define my total net worth as all sheltered and unsheltered assets, but I do *not* include my house (fully paid off) and physical gold (measured in ounces not dollars). Of course, there have been substantial expenses such as college educations and weddings (in that order thankfully) along the way that seemed to rip my liver out through my mouth, but that's life. (Corporate accountants, of course, would call them “items” and pretend they don’t exist.) This is my accrued wealth with no alibis.

Gross Salary- I extract my gross salary from line 22 of my 1099 IRS forms. The rising salary includes inflation, elevating professional rank, merit-based raises, and fluctuations in (but generally rising) non-salaried income. By comparing assistant professor salaries in 1980 and 2009, I can estimate that an overall 12-fold rise in salary derives from a 4-fold inflationary effect (5% per year over 30 years) and a 3-fold real gain—the gain relative to the 2009 rookies. We all know, however, that lifestyles adjust as well. I live simple but not quite like an assistant professor.

Gross Salary Multiple- I define gross salary multiple as my total net worth divided by my gross salary. This is wealth measured against the moving benchmark of a rising salary.

Figure 7 illustrates a plot of Gross Salary Multiple verus years of investing. I cannot fathom retiring with less than 20 annual salaries (20 multiples) safely stashed away; it would be too scary. The harsh reality is that I am not even half way to my target and am 16 years shy of age 70. Of course, conventional wisdom with all its aggressive assumptions about returns on investments, aided by 16 years of saving, says I'll get there without breaking a sweat. I am not so sure.

NB-Year 28 has an arithmetic error, causing the spike. (1/3/10)

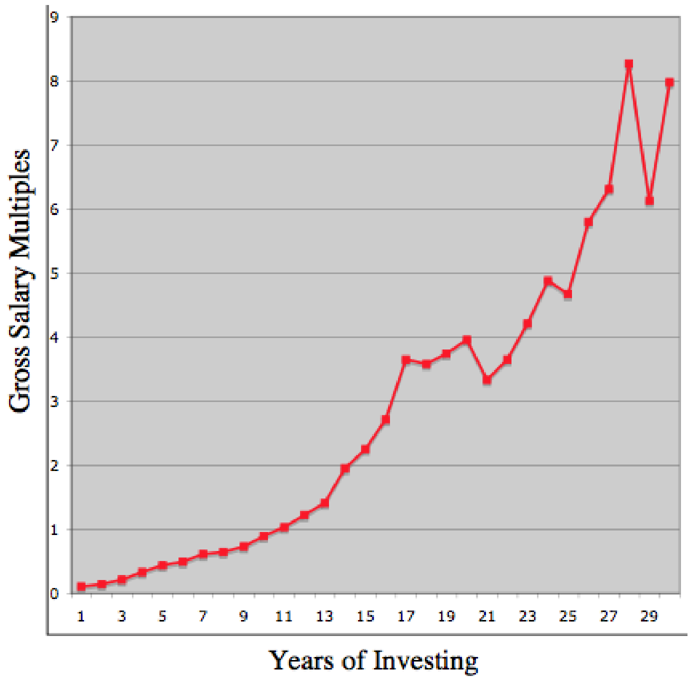

Figure 7. Plot of accumulated wealth as defined by Gross Salary Multiples (see text) versus time (1980-2009).

2010-20: The Toughest Decade?

There are no *Mission Accomplished* banners hanging in my office. My pessimism stems from growing problems that look ominous, bordering on unsolvable. These concerns are presented in no special order as follows.

Inflation vs. Deflation. We have over consumed and malinvested, all the while endorsing flawed Keynesian and monetarist models. The Austrians are clear on this point and seem to be correct: big booms lead to big busts. Faith that the Fed can find both a magic moment and a miraculous mechanism to undue their tangled web of interventions so as to avoid disaster may be misplaced—not every problem has a tidy solution. The question is not will the markets exact their revenge for the excesses (they will) but will we suffer from inflation or deflation. Such a binary language is admittedly too restrictive for such a complex debate, which leads to a lot of shouting. With that said, I am agnostic but leaning toward inflation. If the banking system collapses, deflation could ensue.

Assuming collapse is avoided, however, inflation looms large in my opinion. The Fed's quantitative easing is pumping the system at full throttle, and the government is spending like drunken sailors (no offense to drunken sailors). All that money and all those departures from the principles of free markets will eventually get into mischief. Those who endorse global currency debasements as the solution are total idiots. Global inflation will translate into global suffering. My own portfolio will remain dominated by inflation hedges, with only physical gold outside the banking system as protection against systemic collapse and treasury-backed money markets as a hedge against downward asset repricing.

Resource Depletion. Soon after moving into energy-based investments I began reading about geology and energy production and hit upon the peak oil thesis. After a half-dozen books and countless articles and blogs, I have stopped studying the problem. Peak oil—that fateful moment in which global oil production reaches a maximum—is unquestionably real, coming sooner than most people can imagine, and of truly dire geopolitical and economic consequences. It's a game changer. Thus, I am bullish on energy at least in the near term. This stems from the belief that energy will get harder to produce, and it hedges inflation. What really gets my juices flowing is that it will be important whether the economy stinks or thrives. Because energy is global, I do not need to know *where* on the planet energy consumption will take place. And, of course, energy consumers are second only to smokers in their resiliency. I *really* like natural gas. We will have to worry about that post-apocalyptic economy at a later date.

The Next Crisis. It sure feels like there will be another crisis fairly soon. The particularly shortsighted behavior on Wall Street—the complete disregard by investment banks to heed the eroding public perception—puts them at great risk of being denied another big bailout. Triggers to watch for include a projected global food shortage as soon as next year, a tsunami of mortgage resets coming in 2010-12, a stock market downturn from what looks like a spectacular bear (beer?) market rally, China pulling the plug on US debt purchases, or sovereign defaults in Southern Europe (Club Med). Curiously, history argues against pandemics and wars as triggers.

Debt and Liabilities. Plots of various forms of debt to GDP are legion, and all show unsustainable rises. The situation, however, is worse than that. Peter G. Peterson of the Council on Foreign Relations, Larry Kotlikoff of Boston College, and David Walker, former head of the Government Accounting Office and now head of the Peterson Foundation, all estimate that unfunded liabilities exceed a $100 trillion. This is a headwind without precedent. Those proclaiming the end of the American empire focus on a looming default. The 100 million or so viable taxpayers do not have $1 million each to pay this bar tab. It is unclear whether we will witness a formal default, promises denied, or runaway inflation. It is a foregone conclusion, however, that some form of default is coming. It's not rocket surgery.

Derivatives. Mechanisms for hedging market risk have been around since the 17th century (probably longer). Derivatives in their most benign forms are simply insurance policies. Unfortunately, there is nothing benign about an unregulated $1 quadrillion (with a "q") market in profoundly complex financial instruments with a doubling time of about 2.5 years. This is the sequel to *Andromeda Strain*. Derivatives are the quadrillion pound elephant in the room. For those who think this can go on forever, imagine stacking toy blocks. You got it: The higher the stack gets the more shock sensitive it becomes and the larger the pile of debris when it falls. We must find a way to remove the risk from society at large, but I don't think it's possible. Got gold?

Generational Changes and Demography. As an investing class, the boomers are finished. They have finally had their come-to-Jesus moment and now realize there's no free lunch. Debts are due and retirement (or lackthereof) looms large. Many still have big bills such as weddings and college educations for their kids in the future and and are carrying underwater mortgages. The average 55 year old was reputed to have $42,000 in their retirement account before the market tanked. I don't know if this is true—I got it off the internet!—but I bet it's pretty close. This aging population will be selling equities and over-sized homes to a succeeding generation that does not have the resources to meet their asking price. This is a heck of a head wind for investors.

Banking Cartels. A viable banking system is a critical lubricant to facilitate the flow of goods and capital. As middle men, the bankers take their cut. Of course, we all know that the bankers of the world—the money changers—are a bunch of thugs. There's always a little raping and pillaging around the margins, but during prosperous times it is kept to tolerable levels. Something has changed. The banking system metastisized into a flesh eating bacteria (or squid if you wish), rapidly killing the host that supports it. The latest crisis has shown the true colors of the banking system—a global cartel unrestrained by political boundaries or politics. It controls all of the money, the credit markets, and the authority to create more money at will. It is a crime syndicate, and I am *not* speaking metaphorically. Central banks were created as lenders of last resort, but to the member banks rather than us. It is not about some distant relatives of Rothschilds or Rockefellers as the puppet masters, but rather millions of cubicles filled with young punks attempting to suck nutrients from the system without offering anything in kind. I do not wish, however, to underplay the importance of the wealthy and powerful. Over decades there have been select individuals—conspiracy theorists—questioning the methods and motives of powerful forces that run the world from behind closed doors. To be labeled a conspiracy theorist is intellectually demeaning and is designed to shut down discussion. Well, I happen to be a conspiracy theorist. I'll go a step further and state that anybody who claims that those with wealth and power don't conspire to use and, at times, abuse their wealth and power has a lot of explaining to do. I used to detest the liberal tripe about how the rich get richer and the poor get poorer. It seemed so anti-capitalist. Unfortunately, the anti-capitalists now have the high ground. The rich are getting profoundly rich, and I am not referring to modern day captains of industry like Michael Dell, Bill Gates, or Steve Jobs. You might have noticed that nobody is angry at these guys. What the anticapitalists don't understand is that what we are witnessing is no longer free-market capitalism. Whether you call it state capitalism, crony capitalism, socialism, or fascism, it no longer efficiently moves goods and capital to their most appropriate destinations. The most important market of them all—the market in which borrowers and lenders exchange capital—is no longer a free market.

Big Government and Loss of Civil Liberties. I was a big fan of privatizing government services, but I have reversed course. As Hayek suggested, the problem is not with monopolies per se but when they commandeer the machinery of government. Well, we are there. The Supreme Court ruled that emminent domain can be used by private corporations to take property (at market value as deemed by government) if it is for the good of the whole. The private contractor system that supports Halliburton and KBR has become a multibillion dollar money grab, in which acumen of acquiring the contracts matters whereas quality of product and service does not. (Naomi Klein tells harrowing tales of this in "The Shock Doctrine" that have elements of truth.) Removal of borrowing caps on the nationalized morgage buyers Fannie Mae and Freddie Mac is said to be both extralegal (only Congress should be able to do it) and an ominous sign that the interventions in the mortgage market (or whatever you call it now) are about to ramp up. The Audit the Fed campaign initiated by Ron Paul and propelled by Alan Grayson is gaining momentum; the oxygen will be sucked out of the room when that gets shut down. Obama, the agent of change and hope for the future, has staffed his cabinet with a bunch of neocons as far as I can tell. He's smart, articulate, and just as crooked as the rest inside the beltway. The steady march to a cashless society means that the banking cartel will insert itself into *every* transaction. The move to prevent redemptions of money market funds is either a prudent safeguard against a bank run or step toward Hedgefundistan. A bill moving through Congress will supposedly give the Whitehouse a $4 trillion dollar slush fund to bail out the banks during the next crisis. Politicians like it because they will not wish to vote on a new bailout bill in the face of 100% public opposition. The unlimited capacity of the bankers to raise interest rates on credit cards to any level for any reason makes me want to use only cash out of principle (and buy more guns and ammo.)

Civil Unrest. The average person on the street understands how bad it is and who did it. Another turn down will get very ugly. I would not be surprised to see angry mobs dragging bankers and politicians from their offices and beating them like baby harp seals. (Bankers can take only limited solace in that lamposts are now too high to hang them from.) What would certainly be denounced as senseless violence by official sources would be viewed by others as patriots fertilizing the Tree of Liberty. Government should be afraid of the people, not vice versa.

Post Traumatic Stress Disorder. Casual readings of neurophysiology suggest to me that I have been hardwiring my brain for pessimism. War veterans come back with issues that linger. The greatest generation was left with a world view lasting their lifetimes. I wonder if when that fateful moment comes in which no sane person on the planet is optimistic—that critical moment when only the really crazy guys could look to the future and see blue skies—will I be able to muster the optimism and start investing in the next economic boom?

Acknowledgements

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