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CAPITAL MANAGEMENT

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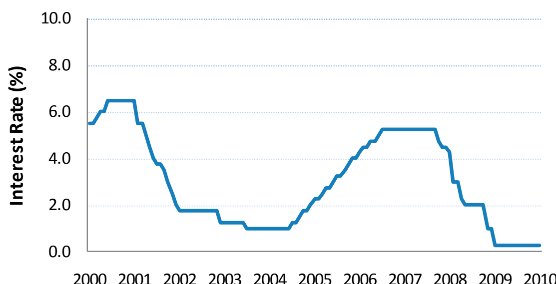
THE DECADE OF BUBBLES

by Tom Loucks

From a financial perspective, the first decade of the 21st century consisted of a bubble of bubbles. First of these was the technology or dot-com boom that began in the late 1990's and eventually burst in mid 2000. Responding to this collapse, the U.S. Federal Reserve (the central bank of the United States) aggressively cut short-term rates from 6% down to the 1.5% range in 2002 and held short rates at this level for over three years.

By 2007 these ultra low rates, combined with easy credit, lax mortgage standards, complex securitized financial instruments and irresponsible bond rating agencies, created further bubbles in real estate, mortgage securities, stocks, commodities, derivatives, and even outright fraud. Speculative asset appreciation had encouraged a virtual "something for nothing" mentality in the minds of investors. Greed and negligence infected the investment and banking communities, their clients and elsewhere. As we all know, these latter bubbles burst in 2008. Shortly thereafter, the U.S. Federal Reserve pushed short-term rates to historic lows (virtually zero) where they currently remain.

Bubbles are caused by central bankers and abetted by federal governments when they create more paper money and credit, via artificially low interest rates, than the real production of goods and services within a nation. Bubbles represent the temporary illusion of wealth, rather than true wealth creation, and are thus unsustainable and destined to burst.

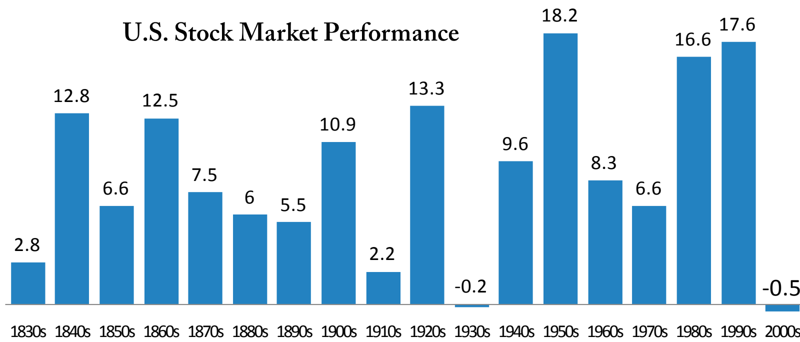


Despite the dramatic rebound in the stock markets in 2009, this decade of bubbles produced dismal returns for U.S. investors. U.S. stock markets posted their worst performance for any calendar decade in nearly 200 years of U.S. stock market history. Even including dividends, U.S. stocks lost an average of 0.5% a year for the decade. (In Cdn dollars U.S. stocks had an annualized return of -3.6% for the decade). U.S. investors would have been better off investing in pretty much any other asset - even stuffing their money under a mattress.

U.S. investors were lured by the fact that U.S. stocks ended the 1990's with a 17% plus average annual gain for that decade – one of the best in history. Unfortunately, trading near all time valuation highs, stocks at the end of 1999 had simply become too expensive.

Similar to U.S. financial markets, the U.S. economy experienced one of its worst decades on record. The standard of living for the typical American consumer stagnated as real median income remained on par with 1999 levels. This fact is remarkable given that over the last ten years the U.S. experienced the greatest expansion of government and consumer debt in its history (both of which the consumer will ultimately pay). Long-term implications aside, the short-term effect of trillions of dollars of additional debt should have had a more positive impact on U.S. growth and living standards. That it did not implies that the U.S. could be nearing the point where additional debt has no net benefit to the U.S. economy.

Canadian markets did somewhat better with the TSX providing an average return of about 5.5% a year for the decade with dividends included. Investors should be reminded, however, that early in the decade most Canadian investment advisors strongly recommend international investments, which similar to the U.S. experience, also produced poor returns.



Canadian bonds provided decent returns for the decade as long-term rates continued their secular decline. However, a repeat of this decade's performance is mathematically impossible. Until long rates rise, which is very likely at some point in the near future, bonds will produce modest returns, or even losses, if one is not knowledgeable and careful.

Our returns this decade on your behalf were moderate, but better than average and solidly positive – something many investors didn't achieve. More importantly, these returns were achieved without the violent downside swings encountered in the stock market over the decade. The risks we took with your money were also modest, partially because we foresaw the dangers, but also because we have no financial incentives to take foolish risks with your money. This decade many investors, especially those south of the border, learned the hard way about how difficult it is to rebuild a retirement portfolio after substantive capital losses (unless, of course, one has a lottery win). Unfortunately, bailouts are for banks, brokers and car manufacturers, not individual investors.

The current interest rate environment presents investors with a serious dilemma. Returns on safe, liquid short-term assets are essentially zero. On the other hand, investments with even moderate, low-digit returns require investors to assume an uncomfortable and uncommon level of risk.

Quality yields of any significance are simply non-existent at this time. A higher yield on an investment will attract the attention of investors, however, many investors are not willing or interested in studying the intrinsics of the investment. For such investors, the higher yield itself is reason enough to invest. Reaching for yield now only produces, as many investors have experienced yet again, the distinct possibility of capital losses greater than the extra yield obtained.

The last couple of years were not just a "bad dream". The U.S. is cleaning up the mess from the largest financial collapse in history. The repricing of the U.S. housing stock, the right-sizing of the economy, and the re-positioning of labor and capital resources will be a long, drawn out affair. Potentially, too much complacency has set in with the rapid rebound of the stock markets in 2009. Returning to the "old ways" of investing could just create another bubble.

Patience is the solution. Capital preservation is paramount until risk declines and the constantly changing markets create better opportunities for serious investors, which is inevitable, and may be soon. The future is bright, or at least as bright as it can be, as it always is for patient, serious investors. Modest short-term returns tend to lead to better medium term returns. It is the unsustainably good short-term returns that lead to medium and long term pain.

The price you pay for an asset is the major determinant of the return you will achieve - a primary axiom of investing. So, until lower risk, higher returns are available we will continue to seek investments with reasonable cash yields, without risk of catastrophic loss, i.e. ones that are prudent for your objectives. We continue to focus on investment themes in seeking out investment ideas, but now, as much as ever, investing is on a stock by stock basis.

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