

Dueling Fairy Tales

Wall Street repeatedly employs Goldilocks as a metaphor for the state of the economy. On the surface, one can see why this heartwarming tale of a thieving heroine might appeal to the investment industry, but its use is limited to crediting the Federal Reserve, the metaphorical cook of Baby Bear's oatmeal, for things being "just right." (Does it bother you that Mama Bear's medium-sized bowl of oatmeal being too cold while baby bear's small-sized bowl of oatmeal is "just right" seems to violate the known laws of thermodynamics? Or is it just us?)

In investing, it pays to be contrarian; perhaps we should find a better, more useful fairy tale. Our suggestion is *Peter Pan*, about the boy who never grew up and his fairy sidekick Tinker Bell. J.M. Barrie, a British novelist and playwright, wrote *Peter Pan*. When Barrie was six, his gifted and popular older brother David died in a skating accident. Barrie's parents never recovered from this death and were, at best, emotionally remote to their surviving son. David's death was at least part of the inspiration for Barrie to create Peter Pan, the never-aging boy. Barrie himself stopped growing at a height of five feet, possibly the result of psychogenic dwarfism, willing himself not to grow up. Charming fairy tales sometimes originate in the tragic or creepy.

In Peter Pan, fairies cannot exist unless we believe in them. According to the logic in Barrie's play, even if we now believe in fairies, if we come to doubt them later, they will die. In the play, the audience's belief in fairies, signified by clapping, saves a poisoned Tinker Bell from death. Many social conventions are subject to this Tinker Bell effect, existing solely because of our belief in them. Do you believe the Federal Reserve will bail us out of the housing fizzle, and that the subprime mortgage crisis is contained? Clap your hands. Do you think the derivatives behind many investments today will behave exactly as the holders think they will? Clap your hands. Do you imagine that everything will go well with your investments because you need the money to retire? Clap your hands, loudly.

Consider the humble money fund, repository of the liquid funds of consumers and investors. It is easy now to forget that money funds are relatively new. Savers used to keep their money in fixed-rate passbook savings accounts at banks. The first money funds started in the early 1970s, an inflationary era. The money funds, investing in corporate commercial paper, could pay investors substantially higher interest than the fixed-rate passbook account.

Still, many savers lived with the memory of the Great Depression bank failures. The backing of the Federal Deposit Insurance Corporation (FDIC), created in 1933, was still important in the 1970s. The notion of writing a check and sending it off in the mail to buy shares in a money fund not backed by the FDIC was not comfortable at first. Greed for the higher interest returns slowly overcame the fear. Getting over this discomfort was a key in sparking the great bull market of the 1980s and 1990s; once money was in a money fund, it just took a phone call to transfer it to a mutual fund that invested in the stock market.

Once the stock market started going up, it became easier to make that phone call. Not many people worry today about deposit insurance or the geographic location of their investments. And this is a good thing – the more convenient investing is, the more people are likely to do it. Confidence is the oil that allows the machinery of modern finance to run. Nevertheless, the

*“Nothing is so firmly believed as
when we least know.”*

– Michel Montaigne

investor confidence behind the financial revolution stems primarily from the fact that not much has gone wrong. Overall, it has worked, but the markets have had long cycles up and down in their history. They will not necessarily always “work” for investors.

For example, what if one day your money fund “breaks the dollar” and goes below the normal \$1 per share net asset value? This happened years ago to an institutional money fund that liquidated at a loss of 6 percent for its shareholders. No retail money fund has ever “broken the dollar”, but this is due only to the largesse of the fund sponsors. There have been instances of defaults in the commercial paper market lowering the net asset value of certain funds below \$1 per share, but the fund sponsors bought the defaulted paper back to make the money fund whole – in other words, pretending that the asset value never declined. This works if you have a wealthy sponsor and it is an isolated incident. If there is a more systemic commercial paper failure that affects many funds, breaking the dollar is probable. No fund sponsor wants to break the dollar, but there is safety in numbers. If there were a widespread decline in the net asset value of money funds, would investor confidence die, like fairies, because we stopped believing? Would it send us back to the dark, low-valuation days of the 1970s? How would you react?

If you believe, clap your hands. If you would like to do something more useful, call us at (503) 419-3938 or check us on the web at www.sigmainvestment.com. If history tells us anything, it is that what you believe today may not be what you believe tomorrow. Times change. Someday, we fully expect to be debunking “Chicken Little” for you.