

Rules for When the House is on Fire

Writing this feels like a no-win proposition. If we avoid addressing the chaos in the financial markets, it looks like we are obtuse or hiding. If we discuss specifics in a world of rapid-fire crises, it will be out of date by the time you read it. Still, here are some basic principles that we believe apply:

1. Safety in the financial markets is always relative, never absolute. If you panic, where do you go? Money funds may own securities of firms about to go under; banks may be on the brink of failure (just ask the former IndyMac depositors), T-bills subject you to loss of purchasing power from inflation, bond funds may be loaded up with illiquid derivatives. Real assets may protect you from inflation, but not an economic decline or deflation. Hedge funds and various other alternatives are just a repackaging of the basic categories of assets. There is no type of investment that solves all the problems, no possible decision to opt out of risk. The best that any of us can do is to make a rational, conscious and knowing acceptance of which risks to take.
2. Whatever complaints you may have about our government, you cannot complain that they are ignoring the recent chaos in the markets. Fed Chairman Bernanke has spent most of his career analyzing policy mistakes surrounding the 1929 stock market crash and the Great Depression. The current crisis is the primary focus of the Federal Reserve and Treasury Department. They are not prescient and they will make mistakes, but underestimating the importance of what is going on is not one of their faults.
3. This is not a time for economic or political orthodoxy for policy makers and, fortunately, it appears as if they appreciate that. When your house is on fire, it is not the time to lecture others about unplugging the iron after each use or turning off the coffee maker in the morning. The first orders of business are to get everyone to safety and then put out the fire. The regulators are operating on an ad hoc, case-by-case basis to address the problems as they arise. They are making many difficult decisions in real time, and we believe they are reaching a generally appropriate balance between saving financial market liquidity and punishing bad behavior.

4. Chaos is out there in wait, and there is no avoiding it. If, two years ago, we said Lehman would be bankrupt, Fannie and Freddie would be in conservatorship and regulators would force Merrill Lynch and Bear Stearns into shotgun weddings, you never would have believed it.

5. Markets are amazingly resilient, considering. If we convinced you, two years ago, that those same things would happen, where would you have guessed the stock market would be? Probably at considerably lower levels than what we “enjoy” now.

6. During the 1970s, the nation’s president and vice president resigned and we were sitting in interminable lines at the gas pump. The unemployment rate exceeded 10 percent in 1982. In 1980, inflation peaked at 14.7 percent and the prime rate peaked at 21.5. While this shows it can get worse, we lived through it all then and we will live through whatever happens now.

“Character is not made in a crisis – it is only exhibited.”

– Dr. Robert Freeman

7. You face four categories of risk; the first three are: (a) longevity risk (you outlive your portfolio given your spending rate); (b) purchasing power risk (inflation diminishes your principal and income values); and (c) capital loss risk (the market goes down). Today, everyone worries about capital loss and ignores the other two. Nevertheless, you still face all three.

A panicked attempt to fix one puts you in greater jeopardy of the other two. The fourth risk is behavioral – that greed or fear will cause you to exchange a reasonable portfolio for an inappropriate one.

8. You might get the direction right, or you might get the timing right, but probably not both – and if you do, it is the result of luck. There is always the notion that the “experts” make all the right moves, but that is a fantasy. Navigating the financial markets is hard for everyone.

9. Consider incentives. Investment banks and brokerages with proprietary trading desks have traders who receive big personal bonuses if they take huge gambles that pay off ~ let the risk management staff worry about the effect on the firm or its customers. Banks offer you a fixed rate and keep whatever they can make over that – another incentive to assume risk. In both cases, there is a potential conflict of interest between what the customers want, what the firm wants, and what the individual employee wants. In contrast, the custodians we use for client accounts are service businesses that simply collect fees on the accounts they retain. Sigma is the same way – our interest is not in a short-term market coup but a long-term client relationship.

10. Recognize that mistakes will be made in any portfolio over time. Heck, no need to use the passive voice ~ **we** will make mistakes and the managers we select for clients will make mistakes. Those mistakes, however, will be a part of an honest game; part of what we believe is a reasonable process. We have aligned our incentives with those of our clients.

Panic is not a strategy; you should have a long-term plan to achieve what you want through investing and not merely react to events. The key to success is to have a process you can trust implemented by people you can trust. If you have any questions or concerns about what is going on in the markets, please give us a call. It is what we are here to do. We are at (503) 419-3938 and www.sigmainvestment.com.