MV Capital Management Thought Leadership

2011: The Year in Review

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Much of what happened in investment markets over the course of 2011 made very little sense to the thinking person, but the year appears to be ending in a way that we think is fitting – that encapsulates all the weirdness of the past twelve months. On the first trading day of this year the S&P 500 closed at 1272. As of the opening bell on December 28 the index stood at 1265. Yes – in a year where the only constant, predictable watchword was volatility, when it was a rare day indeed when major indexes did *not* close up or down by 1% or more from the previous session, when you could close your eyes at 3:45 pm and open them at 4:00 pm to find that the market had moved hundreds of points – in this year the most widely followed barometer of US equities…went absolutely nowhere. If the last two trading days produce little in the way of directional movement (a big if, to be sure) then broad-market US equities investors will pocket a couple cents on the dollar in dividends and call it a year. All that noise, all the stomach-churning ups and downs, proved in the end to be nothing more than a souped-up car with a bad muffler pointlessly spinning its wheels in the mud. And that is a fitting end to 2011.

What does it all mean for 2012? We will share our views on the year to come in our Annual Market Outlook to be published next month. For now, let's go back and review the year gone by for the good, the bad, and most of all the ugly.

Risk On / Risk Off

Once upon a time there was this quaint idea that the price of a stock actually had some relationship to the underlying value of the company it represented. You looked at all the widgets that Company ABC made – how Company ABC obtained the materials and the labor to produce those widgets, how effectively it used sales & marketing channels and messages to sell them, how much people actually wanted to buy those widgets, how many other companies sold similar widgets – and figured out on that basis how much Company ABC was worth. Every time a new piece of information came to light – an earnings report, a new entrant into the widget market, a product quality problem – analysts would factor the new information into their value estimations for Company ABC and the stock price would move accordingly, instantaneously, efficiently.

Okay, that's how it was supposed to work in theory. Markets have never been quite as rational and efficient as the theorists (and some of the more doe-eyed practitioners) insisted. But there was arguably a relationship of some positive correlation between price and value. That relationship has become considerably harder to justify in light of the paradigm which came to dominate 2011, popularly known as "risk on / risk off". Under this paradigm the notional intrinsic value of any publicly traded company on any given day doesn't matter. What matters is the collective "feeling" of the market on any given day, or to be more precise, how the mathematical algorithms embedded in powerful technology platforms situated less than a stone's throw from the stock exchange or electronic communications network "feel" about the data points flooding their neuronal networks.

Each algorithm works according to its own programming, but one thing they all tend to take into account is momentum shift. In other words, if a couple high-frequency systems decide that their data points indicate a screaming "sell", then they unload shares into the market. Other systems "feel" their pain and kick off their momentum triggers. Voila – risk off. Next day after all the dust has settled – perhaps risk on again. 2% or more in both directions – without a single view whatsoever expressed about the intrinsic value of any individual stocks.

Macro Dominance

Part of the reason why it is so hard to pin a value on those underlying cash flows that are supposed to make up the fundamental value of Company ABC is that the background macroeconomic context is more uncertain than it has been at any time since the end of the Second World War. The end of that awful war, which had been preceded by global depression, brought about a period of long-term stability and growth that, when viewed in the long-term sweep of history, is the exception rather than the rule. Probably more than anything else, the far-sighted decision by the United States to help Europe rebuild from the ashes of war, through the Marshall Plan and the economic framework of the Bretton Woods agreement, enabled this long-term prosperity. But any institutional infrastructure, no matter how robust, grows stagnant with the passage of time. If 2011 served no other positive purpose, it did us a big favor by driving home just how rotten to the core our institutions have become across the board. Unfortunately these institutions are failing at a time when the world's most developed economies could sorely use some intelligent guidance.

Certainly the spirit of the visionary architects of the Marshall Plan was nowhere to be seen on the banks of the Potomac River this summer, as reckless politicians with a grade-school grasp (at best) of economic policy played chicken with the full faith and credit of our national accounts. Neither was a spirit of community to be found among the nations of the European Community, which have treated us to an agonizingly slow burn towards some outcome that appears to be more dire by the day. EU policymakers have shown that they understand nothing better than how to kick the can down the road, when even the *Economist* magazine starts penning obituaries for the Euro. How bad would a breakup of the single currency zone be? Nobody really knows for sure, and that is what makes it so difficult to incorporate a realistic macroeconomic context into asset valuations. The world is more interlinked than ever, and the systemic, high-impact risks are ever greater.

Safe(r) Havens

Macroeconomic instability claimed another victim in 2011 in the form of the risk-free asset, and added to the already-daunting asset valuation dilemma. When Standard & Poors downgraded US government debt in the wake of the debt ceiling debacle the ratings agency came in for withering – and largely justified – criticism. However inelegantly the point was made, though, it was a valid point – the credit of the world's number one economy was no longer what it used to be. Now the downgrade arrow has spun over to European sovereigns and not even the most creditworthy of them are assured of being spared. The safe haven asset, that which anchors the discount rate for all other, riskier assets, is less safe than it used to be. Calling anything a "risk-free" asset anymore appears to be decidedly incorrect.

Of course, in the Alice-in-Wonderland world of 2011 the immediate outcome of the US debt downgrade was upside-down. US Treasury securities rallied like howling banshees. The 30-year US Treasury bond produced a year-to-date return over 20% - and proved to be almost as volatile as equities in generating these returns. In a world with very little to offer in the way of positive economic news the US stands on firmer ground than other nations, and on a relative basis this means that Uncle Sam is still in first place on the dance cards of global haven-seekers. But this relative strength does not change the fact that on an absolute basis the world is a riskier place than it was. If you live in a house of straw and mud then you will feel safer by fleeing to your friend's house made of logs and branches. But that does not change the fact that when gale force winds blow you will wish that you still had that castle of stone for protection.

Social Contracts

Capitalism is a curious animal. It relies on continual growth and wealth creation, and ultimately that growth model rests on the foundation of confidence. In a fractional reserve banking system there is never enough physical cash in the vaults to pay off everyone who is a creditor, from the $1,000 checking account to the multimillion dollar bondholder. But the confidence required for long-term prosperity requires more than simply faith in your local (or global) bank not collapsing tomorrow. It requires a general consensus among nations and peoples that the system is in some way fair and oriented towards the good of the many. Capitalism breeds inequality – there is no way around the simple fact that in any capitalist society some people will prosper more than others. That will be okay – to a greater or lesser extent depending on socio-cultural context – as long as there is a general sense of institutional fairness and accountability. When that is no longer the case – when the prevailing popular attitude arrives at the conclusion that the institutions are corrupt, self-serving and rigged to prevent a level playing field, then a willingness to tolerate capitalism's flaws becomes lessened, and confidence breaks down.

2011 was a year of protests. Even that avatar of conventional wisdom, *Time* magazine, anointed "The Protester" as the Person of the Year. From a solitary man in Tunisia setting fire to himself in protest against a nepotocratic regime, to public squares named Tarhir and Zucotti, among others, to the shadow of the Acropolis and the red-brick ramparts of the Kremlin, loud public voices rose up to decry the failures of their policymakers and plutocrats. The voices were cacophonous, a jumble of languages and belief systems. But there was one unifying theme across all the demonstrations: We lack confidence, said the protesters, we lack confidence in the idea that our leaders, our institutions and the most well-off in our societies have any agenda other than their own personal enrichment and self-preservation. We don't feel like we are all in this together, that the sacrifices we are having to make are being shared equitably.

One does not have to come down on any particular side of the ideological spectrum to understand how organic and deep-rooted these protests are. In the US there have been meetings where Occupy Wall Streeters and Tea Partiers sit down together to figure out what they have in common rather than what divides them. Many in the so-called "establishment" have looked for reasons to wave this off as a troublesome passing fad. Such types would be well advised to go back and brush up on their Rousseau, their J.S. Mill or their Hegel (depending on one's own philosophical proclivities) and brush up on the meaning of a social contract between states and their citizens. Anarchic fantasies of "everyone for him or herself" does not work as a method for preserving a civilized, functioning, progressive and growth-oriented society. Neither does a clueless Versailles of elite opinion, smug in its own certitude and oblivious to the world outside its gilded gates. Around the world the social contract is in need of renewal, and there needs to be an intelligent, inclusive discourse on how this can be best accomplished.

Back to Basics

On a personal note, while it has been a difficult year in many ways, it has also been a clarifying one. We have had to take a hard, sober look at just about everything upon which our profession is built and ask ourselves what we can do, in this trying environment, to put our clients in the best position to prosper over the course of their financial time horizons. What role do equities have in a portfolio? What methods do we use to achieve the right balance of capital preservation and opportunistic growth, at a level of risk appropriate to each client's individual capacity and propensity to take on that risk? How do we achieve diversification in an environment where hedge funds and commodities track the S&P 500 with correlations of 0.7 or higher? What valuation methods work in an age where rational expectations appear not to?

Our inboxes are inundated every day with asset managers who seem to have appeared out of nowhere, touting the latest short-term strategy. Buy and hold doesn't work any longer, these current-day incarnations of carnival snake oil salespeople loudly proclaim. It's a short-termer's market – you need to be in for the kill and out for the kill if you want to make money in this environment. But what not one of these Johnny-come-latelies is ever able to do is to articulate a clear and convincing explanation of what actually *works* in this brave new short-term world. Is it a better algorithm? One whose server is parked just a couple nanoseconds closer to the exchange? If so, how do you argue for the ability to generate sustainable outperformance when your entire strategy goes out the window the minute some fund with another algorithm is able to jam its servers just a little bit closer to the NYSE trading posts?

These are not unintelligent people. They use the daunting language of probability and statistics and opaque "back-testing" methodologies to make it sound like their fund could never do anything other than earn double digit returns in any and all market environments. But ultimately they are dealing in vapors, not in anything grounded or substantial. At the end of the day equities are still equities and bonds are still bonds. Either Company ABC can figure out how to sell enough widgets to grow at a sustainable 5%

annual EPS rate or it can't. A bond will either pay interest in full on a timely basis until redemption of principal, or it will default. Beyond these and a handful of other basic precepts, all finance is derivative. As much as many of its practitioners desire to make it resemble particle physics in complexity, it is in reality a pretty meat-and-potatoes business. We believe that a return to basics is more likely than not to be a defining trend of the near to intermediate future. That is not to say that it is now or will be easy – quite the contrary. We have plenty of blind curves ahead, and who knows what is on the other side. But we believe that the dominant current trends of risk on / risk off and chronic volatility are not sustainable. The institutions, regulations, practices and indeed purpose of modern investment markets were not built for the kind of activity that dominated in 2011. At some point, we believe, change will be necessary and change will of its own accord happen. In the meantime we intend to stay fully engaged, with all the patience, discipline and critical thinking that we have always brought to bear.

May the New Year be a joyous, peaceful and healthy one for you and your loved ones. See you in 2012.

With warm regards,

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