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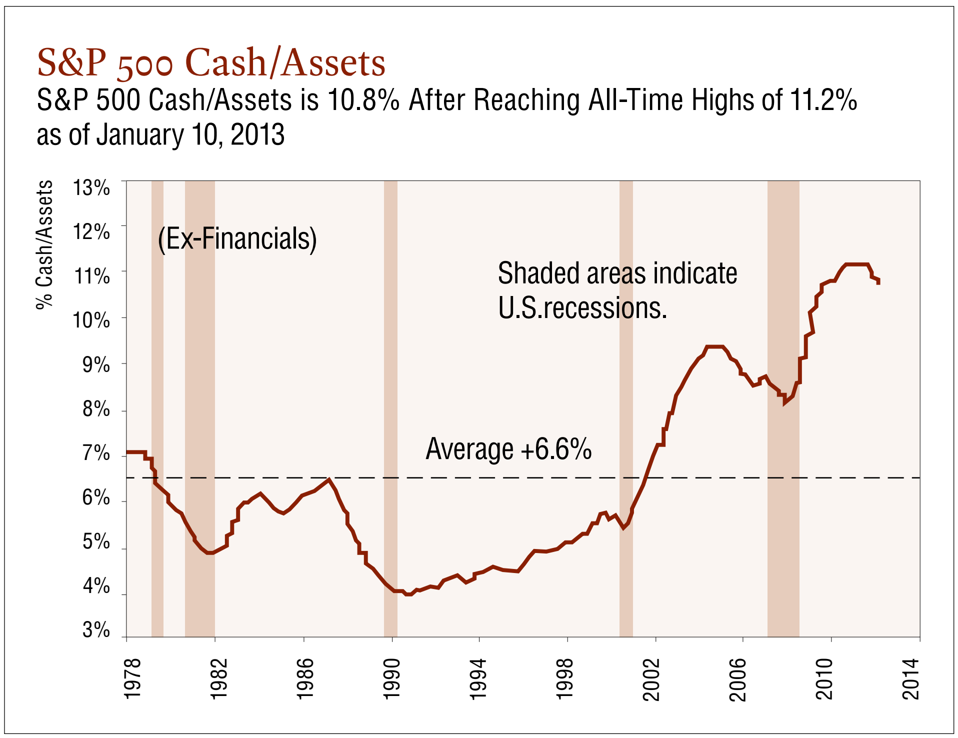
Editor's Note: With all that has happened and not happened since the beginning of 2013, this quarter's newsletter takes a more detailed approach to exploring where we are now, and where we might go from here, combining our market outlook and educational articles into one. We hope you enjoy our commentary.

Scared Money Can't Win

by Kevin J. Cavanaugh

"He began to feel better than he'd felt in a long time and the weight on his heart had begun to lift and he repeated what his father once told him, that scared money can't win and a worried man can't love."
— All the Pretty Horses, Cormac McCarthy



Source: Compustat and Goldman Sachs Global ECS Research.

With recent optimistic news about the job market, record highs on Wall Street, and having stepped back from at least two ledges of the fiscal cliff thus far, as investors we might relate to the easing of the weight of uncertainty on our hearts. It is an opportune time to turn our attention to all the "scared money" that has been sitting on the sidelines, waiting for productive engagement. This money has several sources. The U.S. Federal Reserve Bank, in an effort to foster growth and financial stability, is producing massive reserves that continue to build up within the banking system. Corporate America is steadily amassing vast amounts of cash on their balance sheets (see chart above showing cash as a percentage of the S&P 500 companies' assets, excluding those firms in the financial sector), while private and institutional investors are also reported to have built a considerable store of money waiting to be put to use.

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But what are we waiting for? Is the economic situation really any more uncertain now than in many past challenging periods such as World War I or II, or the Cold War, or the

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oil crisis of the 1970s, or the terrorist attacks of 2001? We think not. We look back and see that, in each case, the capitalist system survived, the structure of a functioning government remained in place, and the financial markets eventually recovered. And yet, uncertainty continues to drive our collective "wait and see" attitude. In considering how to invest in such an environment, we begin with an examination of three primary reasons for this uncertainty and trepidation: the hubris of economic experts, the elevated levels of debt in the global economy, and the graying demographic of the developed world. Our understanding of these catalysts helps formulate our advice for negotiating a path forward.

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I. Whom to Trust?

While it may be popular to blame politicians, crony capitalists, bankers and speculators for the ills of the economy, we think this idea misses the mark when considering why so much money has been stockpiled. Instead, we consider the role of our economic experts in this crisis of uncertainty. We recall how, in the years after the downturn of the early 1990s, the stock market collapse in 2000, and the subsequent recession, much of the credit for the economic recovery and the steady, moderate growth that followed was given to Robert Rubin, Lawrence Summers, Alan Greenspan and, eventually, Ben Bernanke. Unlike speculators or politicians, who act within a self-serving incentive structure, these confident individuals were acting upon orthodox economic theory, purportedly tested and methodically verified. On this basis, we trusted them.

Then, about six years ago, one of the worst financial crises in modern times began. From 2007 through much of 2009, investors watched as the foundations of the global financial system cracked under pressure while governments and economic experts struggled to reestablish the footings. They struggle to this day. Having misgauged the speculative run-up into the financial crisis, governments and central banks have been attempting to stimulate growth through accommodative fiscal and monetary policies. But the consequences of these policies, and the shaken confidence in our experts' ability to avoid the extremes of these consequences, continue to feed uncertainty. Recently, Richard Fisher of the Dallas Federal Reserve expressed his concerns about the lack of an adequate framework for understanding economic activity and the possible unintended consequences of the current policies:

> **With the additional taxpayers resulting from this population growth, the U.S. is in an arguably better position to meet the obligations to her citizens and financial commitments.**

"The truth, however, is that nobody on the committee, nor on our staffs at the Board of Governors and the 12 Banks, really knows what is holding back the economy. Nobody really knows what will work to get the economy back on course. And nobody—in fact, no central bank anywhere on the planet—has the experience of successfully navigating a return home from the place in which we now find ourselves. No central bank—not, at least, the Federal Reserve—has ever been on this cruise before."
— *Richard Fisher* (September 2012)

We are encouraged by the relative transparency of a new crop of economic experts who, like Fisher, appear to be willing to set aside some hubris in favor of clarity on the issues we face, or might face. In addition, we recognize the limited power of these same experts and their policies to solve all the issues for us. As rational investors, we are much more comfortable in understanding the risks we might choose to take, rather than blindly following these experts under the belief that, as *Time Magazine* once put it, they are the "Committee to Save the World" (1999).

II. Debtors' Prison

Another underlying cause for uncertainty in the global economy is the heavy burden of an accumulating debt load. Over the 10-year span ending in 2011, total credit market debt in the world grew from $80 trillion to over $200 trillion. During this period, global debt grew at a pace of over 10% per year, while global GDP grew at 3.9% per year. Global debt has reached an historic high level of well over 300% of global GDP, about twice the historic norm of 150%. There have been numerous historical studies which have shown that when governmental debt reaches above 90% of the size of an economy, there are harmful effects on economic growth. Currently, it is taking more and more debt to move the global economy forward.

Here in the United States, our government debt relative to the size of our economy has also reached high levels. If you include inter-governmental

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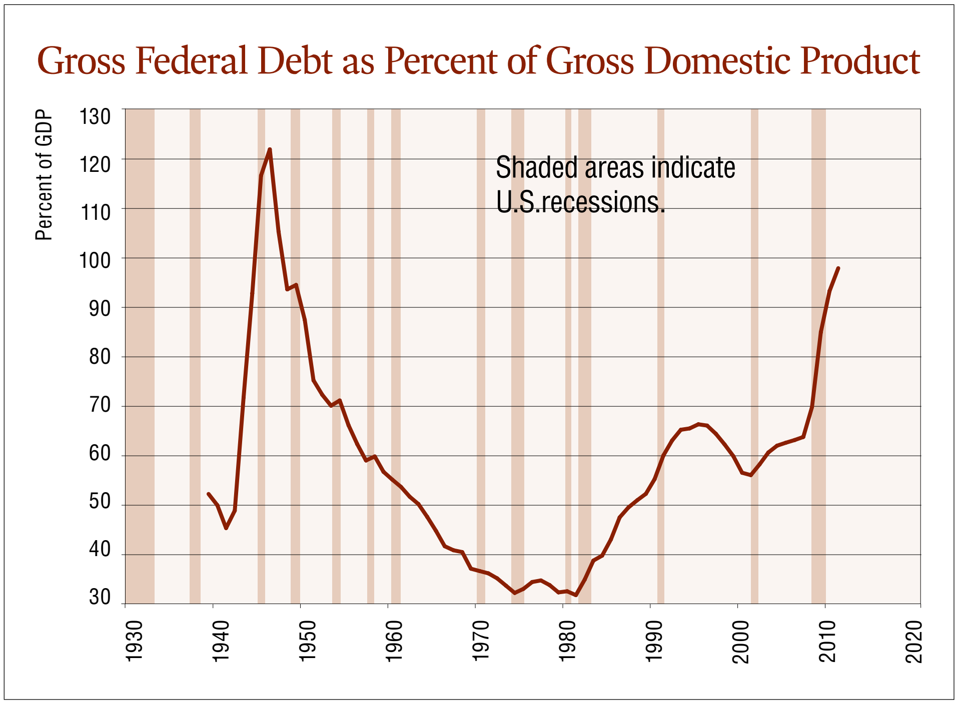
debt, which we think is an appropriate way to measure our indebtedness, the federal debt level is now approaching 100% of GDP (see chart below). If you do not include this, the level is still over 70% of GDP and climbing at a rapid pace. We are adding approximately $1 trillion in federal debt per year on an economy of about $16 trillion in size.



Source: Federal Reserve Bank of St. Louis.

We may have already reached the point wherein any additional debt works against economic growth. As a result, many economists have cut their longer-term growth rate estimates for the U.S. economy. Of course, slower economic growth will not make it easier to work out from under this debt load.

While the scope of the problem is certain, the clear solution is more elusive. We anticipate an increased tax burden on the private sector and a protracted period of very low interest rates, but are uncertain about the timing and ultimate impact of these actions on the private economy. As a result, money has been seeking safe harbor.

III. The Incredible Shrinking Population

If present trends continue, the number of adults in affluent and productive countries will shrink by about a third during this century. According to a United Nations report[I], beginning in about 2015, the adult population of 15-59 year-olds in these more developed regions will start to decline at rate of about 2% per year. Economic growth within these countries will stagnate, or even decline, without significant gains in productivity. Within the developed world, Europe could face the worst problems.

The story is different for the United States. While our fertility rate is decreasing, due to immigration we should experience a growing population (between 15%-20% larger) looking out to 2050. With the additional taxpayers resulting from this population growth, the U.S. is in an arguably better position to meet the obligations to her citizens and financial commitments. By comparison, China's adult population is expected to shrink from 915 million in 2010 to 682 million in 2050, while India's is expected to grow by a third during that same time period. U.S. businesses looking to increase their exports will need to plan for these market variations.

While these demographic trends raise the level of uncertainty, one hopes that the countries in the Arab world, Africa, Latin America and Asia can move toward a more modern, productive position and contribute to global economic growth. These projections, while longer-term in nature, may begin to influence the global economy in the near term.

IV. Moving Forward

We can understand, then, why consumers, investors and businesses are guarded about utilizing the "scared money" which currently accumulates within our financial and economic systems. They observe an increasing systemic debt burden which is expected to be serviced by an aging, less productive population and wonder

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whether there will be the cash flows to meet the financial obligations. They wonder about a set of experts that failed to anticipate the last crisis or two and continue to implement policies that fall short and may, in time, lead to unintended and undesirable

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consequences (high levels of inflation). Businesses look back on the financial crisis and harbor their resources in anticipation of another shock. Stock market investors look back upon two bear market corrections in the last 15 years and worry about more to come.

These are the uncertainties of our times, but is there any reason to believe that scared money will win this time? Not likely. Investors would do well to consider more than our recent past. In "The Lessons of History," Will and Ariel Durant found that, over the long expanse of time, the truly successful investors, such as the Medici of Florence, the Fuggers of Ausgsberg, the Rothschilds of France and London, and the Morgans of New York, were well-informed students of history. The Durants noted that, "Perhaps it is one secret of their power that, having studied the fluctuations of prices, they know that history is inflationary, and that money is the last thing a wise man will hoard."[2]

The pre-eminent investor of our time, Warren Buffett, is also a keen student of history. About uncertainty, he comments: "America has faced

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the unknown since 1776. It's just that sometimes people focus on the myriad of uncertainties that always exist while at other times they ignore them."[3] Far from sitting on scared money, he has recently acquired all or part of Heinz, Burlington Northern Santa Fe, General Re, Lubrizol, PacifiCorp, and Mid-American Energy. Each of these was

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over a $1 billion investment. Moreover, he has expressed an increasing appetite for more and even larger businesses to own. Since 1995, Berkshire Hathaway has acquired 189 companies and taken significant minority interests in another 22 companies. Warren Buffett's biggest worry is about how to prudently invest all the cash that these investments will generate. Another way to express Buffett's concern is that instead of sitting on cash as a defensive investment strategy, he is seeking out the cash flow or the growing cash flows generated by high-quality businesses.

We have stated repeatedly in recent communiqués that secure income streams from quality sources are in increasingly short supply. This has to do with the growing demand for stable income-oriented returns due to an aging, retiring population, and to a shrinking supply of high quality assets due to a slower-growth economic environment and deteriorating government balance sheets.

Scared money can't win. It is not possible to build wealth without taking risk. Like Mr. Buffett, we believe, at present, it is not possible to preserve wealth without taking educated risks as well. We counsel that a prudent level of equity investment in a diversified portfolio of high quality, growing businesses is a conservative strategy. We have a high degree of confidence in both the sound balance sheets and the stable, cash generating characteristics of the companies that we own in our clients' portfolios. If we are careful to invest in these businesses at attractive price levels, we should be able to reduce risk to a tolerable level. Uncertainty, however, will be with us always. ◆

1. UN report on Population Prospects.

2. *The Lessons of History*, Will & Ariel Durant. 1968.

3. *Financial Times*, March 4, 2013.

CLIFFORD SWAN
INVESTMENT COUNSEL

Professionals

Maye Albanez, CFA, CIC
S. David Andrew
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Maxwell R. Pray, CFA
Terrell H. Price
Linda Davis Taylor
Ralph E. Weil, CFA
Bruce C. White
Lloyd Wong, CFA
Randall L. Zaharia, CFA

Offices

Pasadena
200 South Los Robles, Suite 320
Pasadena, CA 91101
626.792.2228 | 626.792.2670 FAX

Costa Mesa
650 Town Center Drive, Suite 845
Costa Mesa, CA 92626
714.846.2851 | 714.668.9302 FAX

Evergreen
P.O. Box 2945, Evergreen, CO 80437
720.746.1244 | 720.294.9896 FAX

www.cliffordswan.com