ECM | Elgethun Capital Management

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What Time is it?

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We believe there are two times in investing: a time to make money and a time not to lose money. Or, as Warren Buffett puts it, “Be greedy when others are fearful and fearful when others are greedy”. The point is, buy when others are forced to sell and blood is running in the streets, sell when prices are high and euphoria and greed rule the day. Prices are the hands of the clock that keep the time.

So, where are we today? In the U.S., prices are high in every income-producing asset class, yet there is little optimism or euphoric behavior. It seems like our clock is broken – normally high prices correlate with optimism and “can’t miss opportunities”, indicating it’s time “not to lose money” or play defense. Instead, there is fear in the air and little optimism, which could indicate it’s time to “make money” or play offense. What gives?

We believe record-low interest rates and “helicopter” central banks have impaired the hands of our clock (or impaired pricing). Interest rates are the primary ingredient to price, so manipulating rates ultimately distorts pricing. According to Bloomberg, as of 19 February, over 25% of developed-world sovereign debt yielded less than zero. Let me repeat that – investors are charged to own over a quarter of the outstanding debt of developed countries! If you’re not confused you should be. See the table below.

World Government Bond Yields, %, Feb 19 2016

Tenor (years)	DENMARI	FRANCE	SWEDEN	AUSTRIA	FINLAND	NETHERLAND:	GERMANY	SWITZERLANI	JAPAN
1	--	-0.40	--	-0.43	-0.48	--	-0.54	-0.97	-0.18
2	-0.31	-0.42	-0.61	-0.46	-0.49	-0.50	-0.53	-1.05	-0.21
3	--	-0.35	--	-0.43	-0.42	-0.46	-0.48	-1.02	-0.21
4	--	-0.27	-0.43	-0.32	-0.34	-0.38	-0.42	-0.91	-0.19
5	-0.04	-0.16	-0.12	-0.26	-0.20	-0.31	-0.33	-0.80	-0.17
6	--	-0.06	--	-0.14	-0.15	-0.21	-0.28	-0.70	-0.16
7	--	0.07	0.13	0.03	0.02	-0.08	-0.18	-0.63	-0.15
8	0.22	0.18	0.30	0.17	0.12	0.06	-0.07	-0.50	-0.11
9	--	0.38	--	0.33	0.28	0.17	0.08	-0.40	-0.06
10	0.52	0.56	0.50	0.50	0.49	0.34	0.20	-0.33	0.01

Source: Bloomberg

Here’s our take: For the past seven years central banks around the world, including the U.S. Federal Reserve “Fed”, The European Central Bank, the Bank of Japan, and others have tried to reignite economic growth by pumping trillions of dollars (equivalents) into their respective economies through quantitative easing “experiments” and by fixing short-term interest rates at zero (now subzero in some countries). The Fed’s purpose or “dual mandate”, amended by Congress in 1977 is: “Maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates."

Essentially, the Fed is tasked with stabilizing prices and promoting growth through monetary policy (interest rates). But there is a problem, world economies aren’t growing and monetary policy, although the verdict is still out, doesn’t seem to solve the world’s growth problems. So, instead of normalizing rates, central bankers have gone with the idea “if it’s not working keep trying harder until it does”. While this is a noble attempt, one poses the question: can monetary policy and negative rates solve our issues, or does price distortion cause more harm than good?

So, what are we doing today and how are we managing your capital?

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Investing with Uncertainty

First, although the hands of our pricing clock are sending conflicting messages, we believe we are squarely in the "time not to lose money" time zone. Too much government debt, too little capital investment, far less tools in the Fed's toolbox should the economy slip further, among other concerns, leaves us holding excess cash and waiting for better prices. We have roughly 20% cash (or short -term investments) in most portfolios, giving us ample "dry powder" should prices fall further.

Second, we have and will continue to high-grade portfolios to businesses we believe can muddle through slow economic growth or even deflation. Some of our businesses, like Fairfax Financial, would actually benefit from poor economic times, while others, like Berkshire Hathaway, have durable businesses and cash to take advantage of cheap deals should they surface. Businesses like Nestle are likely to continue to grow earnings and dividends in even the direst circumstances.

Our focus is always on preservation of capital and risk mitigation. Today, we're mitigating risk by holding 20% cash (in equity portfolios) and owning defensive businesses. This means we're sacrificing potential upside in order to protect the downside, something we think is prudent in the given environment.

Sincerely yours,

John Barker

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