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Same Story, Different Channel

The economic winning streak discussed in our May letter may be coming to an end. Corporate profits are weakening, credit is harder to obtain, and inflation is rising.

Is an economic losing streak at hand? We do not know. Alpine clients need not worry either way. The intrinsic value of true high-grade securities is impervious to macroeconomic cycles. Own quality and you are safe. Alpine clients own quality.

Owning quality, however, does not exempt us from assessing macroeconomic conditions. Valuing enterprises requires knowing where you are in the economic cycle. Moreover, economic crisis can precipitate opportunity.

The story of economic crisis is largely the same in the history of free market economies. Some event creates a boom, the boom is over-financed, and the over-financing ends in bust. Over-financing in general refers to two activities: making bad loans and buying speculatively priced stocks[*].

Speculatively priced stocks were the culprit of the 2000-2002 bust. The Internet revolution created a legitimate boom – investors responded with rampant stock speculation. Alpine clients not only avoided the subsequent debacle, but profited from it.

Today's bust stems from bad loans – many were leant money to buy homes they could not afford. Alpine clients have and will continue to avoid the fallout – our exposure to financial institutions with bad loans ranges from de minimis to nil. As for offense, we are beginning to see opportunities to profit from over-sold assets.

However, Alpine will avoid some investments regardless of how attractive they look. Looks can be deceiving. Today, many financial institution balance sheets are like black boxes. A massive casino of esoteric financial instruments has developed in recent years to which all major banks have exposure. The underlying risk and value of these instruments cannot, in many cases, be reliably assessed.

The casino that financed homeowners also finances hedge funds and private equity. Hedge funds employ complex investment strategies, and oftentimes large amounts of borrowed funds, to buy just about anything from stocks to esoteric financial instruments. Private equity employs large amounts of borrowed funds to buy private companies.

[*] Economists including Adam Smith, John Stuart Mill, Irving Fisher, and more recently, Hyman Minksy and Charles Kindleberger, have described the boom and bust phenomenon, though other economists choose to ignore its existence. They are the same economists who refuse to pick up a $100 bill on the sidewalk because, in theory, someone else would have already found it.

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Both charge substantial fees which create equally substantial fortunes for the fund managers who operate them. A few deserve the fees. (The deserving few are also more likely to avoid excessive borrowing and maintain minimum hurdle returns before their incentive fee is paid). In the vast majority of cases, however, the story is quite different. Here is how it works.

Dazzled by spectacular returns and epic mansions, professional advisors and their clients mistake random upside volatility for brilliant investing and allocate large sums to "alternative asset classes", aka, hedge funds and private equity. One day down the road, random volatility cuts the other way, and poor returns, or worse, ensue.

All of this is eventually swept under the carpet of pedestrian longer run returns – assuming one avoids the major fiascos. The already rich fund managers and professional advisors get richer. Their clients, some already rich via real businesses with real profits, and others perhaps not so much, are none the wiser, and certainly, none the richer.

Avoiding the major fiascos has become more difficult in recent months. The age old model employed by today's players – take large risks, generate large returns, pray the risk does not kill you – does not work so well during difficult times.

The antidote to all of this is to buy only what can be understood; loan money only to those who can pay you back; buy enterprises only at reasonable prices; and pay only reasonable fees for solid long run returns. Simple, but apparently, not always easy.

At Alpine, practicing these principles is like breathing – easy and mandatory. The prize for practicing them is financial peace and prosperity.

On that score, may you experience peace and prosperity, in every area of your life, this coming year.

Nick Tompras
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As of November 4, 2022, we have provided this supplement to accompany the commentary and satisfy changing regulations: https://acr-invest.com/commentary-supplement/

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