MAI VIEW

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Golden Age

Once upon a time the capital markets consisted of a fairly closed community, comprised on one side by mostly clever, well-connected men working together in syndicate to maintain control over national economic and financial affairs, and on the other side by mostly high earners spread disparately across the land hobnobbing with the syndicate's local representatives.

It was a privileged ecosystem sanctioned by legally-greased law makers and reluctantly accepted by the great unwashed that acquiesced because capitalism was better than recently defeated fascism and post-War communism, and because, with hard work and production, they too could join the club.

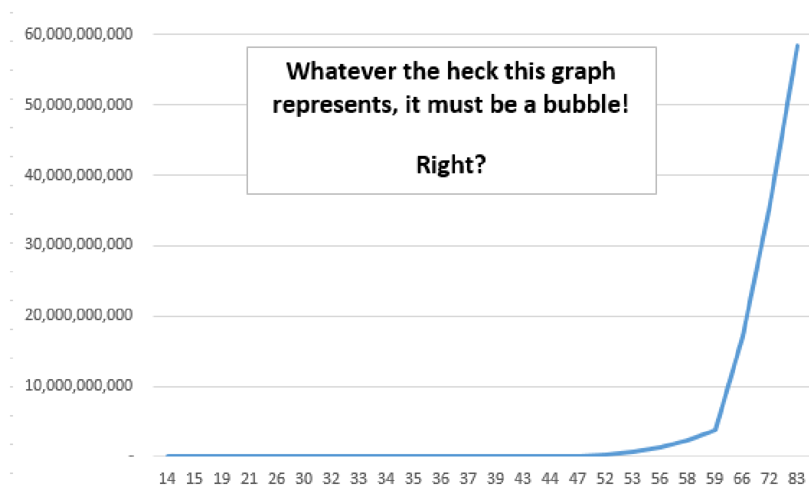
A sequential series of naturally-occurring events successfully transformed and democratized the formerly clubby ecosystem, but in doing so embedded CAT 5 risks into the global productive economy. Consider…

- Over-spending by US lawmakers in the 1960s led to the end of the global fixed exchange rate monetary system in the 1970s. US dollars and global assets could begin to be leveraged without limit. Global exporters of oil demanded more money in exchange for their finite resource.
- In the early 1980s, the value of dollars (i.e., US interest rates) was raised to levels that created demand to hold them again, which in turn allowed global trade could resume.
- Wall Street outsider, Drexel Burnham, using unregulated credit as tool to challenge the control of businesses and asset prices formerly determined unilaterally by the closed ecosystem.
- Self-directed retirement accounts were created in 1986. They were promoted and adopted throughout society and opened the door for widespread interest in stocks and bonds.
- The advent and broad adoption of digital technology in the 1980s and 1990s allowed limitless trade processing and easy record keeping.
- Asset prices rose over time because debt could be easily refinanced at ever lower rates.
- Law makers were consistently corrupted by their access to *unlimited spending,* brought about by the debt-generated appearance of broad prosperity through asset growth and political support from beneficiaries nearest to the credit distribution system.
- Market regulators and economic policy makers were consistently corrupted by law makers exerting pressure on them not to upset the debt-fueled broad economy.
- Economies successfully migrated from emphasizing private sector production and saving to emphasizing public/private financial management of equity and debt assets that cross collateralized government and household balance sheets.

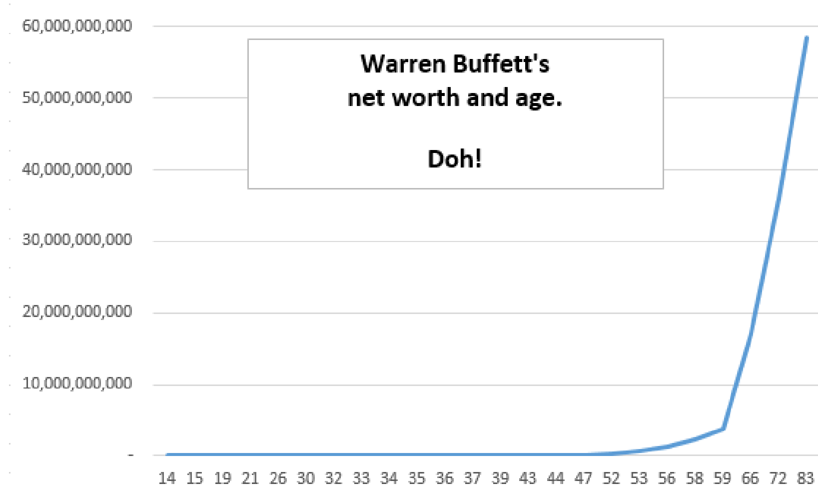
Economies became accounting schemes with mutable identities, which is where they stand today. Most Baby Boomers are blithely unaware or unconcerned about the gutting of production-based wealth creation and the unsustainability of the financially-based global economy they built. Gen Xers have trapped themselves between the unstoppable force of deflationary digitization they are building and the immovable object of The Boomers' Rube Goldberg inflation machine. Meanwhile, most Millennials care nothing of what was and could be, or of the structural changes they will be expected to endure. (Hey, Gen Xers and Millennials, stop voting for 70 year-olds! Find a 35 year-old to help reconstruct your future.)

A Soon-to-be Bygone Era

Check out the mystery graph immediately below. Whatever it represents, we have been trained to think its hockey stick pattern must represent irrationality in some way, shape or form, right?



As we said…



We are fans of Mr. Buffett, admire his talent, and wish him a long, prosperous life, but we could think of no better way than his unquestioned success as a financial asset investor to get readers to begin thinking about what they accept as stable and what they accept as bubbles. While the fact remains that Mr. Buffet has increased his net worth consistently throughout his long life (consistency the graph cannot show because his net worth at fourteen was too small relative to the last few figures), the parabolic rise of his net worth later in life poignantly symbolizes the timing of the underlying shift from production to finance. As he insists in his folksy, humble way, he happens to be the very rare exception in the universe of investors, and if it were not him it would be someone else.

As usual, he is right but oversimplifying things. We can do that too. His investment style, that began as Graham value and drifted into a hybrid that included macro and distressed, always had one unifying constant: inflation. Berkshire and its holdings include insurance and consumer brands with unrivaled moats. All or most of his businesses have had pricing power, which is to say insurance premiums paid today will likely always be higher than claims tomorrow in future dollars, and Coca Cola will likely always keep its profit margins whether a can sells for a nickel or $5. Further, the structure of Mr. Buffet's investment portfolio means he has been able to defer most of his taxes in perpetuity.

Age	Net Worth	Return
14	5,000	
15	6,000	20.00%
19	10,000	66.67%
21	20,000	100.00%
26	140,000	600.00%
30	1,000,000	614.29%
32	1,400,000	40.00%
33	2,400,000	71.43%
34	3,400,000	41.67%
35	7,000,000	105.88%
36	8,000,000	14.29%
37	10,000,000	25.00%
39	25,000,000	150.00%
43	34,000,000	36.00%
44	19,000,000	-44.12%
47	67,000,000	252.63%
52	376,000,000	461.19%
53	620,000,000	64.89%
56	1,400,000,000	125.81%
58	2,300,000,000	64.29%
59	3,800,000,000	65.22%
66	17,000,000,000	347.37%
72	36,000,000,000	111.76%
83	58,500,000,000	62.50%
87	78,200,000,000	33.68%

Mr. Buffet was born in 1930 and so he was positioned to make hay when the golden age of credit and asset inflation arrived. He has been a professional investor for sixty years. He increased his net worth by about 10,000 times in his first 30 years, from 1956 to 1986 (v. the S&P 500, up about 5 times), and by about 55 times in his second thirty years, from 1986 to now (v. S&P 500, up about 12 times). Don't let his folksy humility fool you; his talent allowed him to get rich quick many times over six decades.

We have two main observations: 1) Warren Buffet is that very rare individual who was already well-staked, able to quickly identify the shift from production to finance, and then willing to optimize his investment strategy to suit it, and; 2) he would have performed even better with his original brand of value investing had the US policy makers not encouraged every Tom, Dick and Mary to use the public markets as piggy banks.

Mr. Buffet's experience *in public asset markets* is not repeatable. Already high valuations, investor participation and economic leverage levels ensure that public markets will provide the mass of investors, and even one that may come along as talented as he, with the inability to produce significant real alpha. It was fitting that the Oracle himself predicted last week that the Dow Jones Industrial Average would hit 1,000,000 in the next hundred years. That implies only a 3.87% compounded annual return before inflation. Who are we to argue with the golden boy in his golden years?

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