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VIEWS FROM CAMELBACK MOUNTAIN

The Great Recession - 10 Years Later

We have reached the 10-year anniversary of the financial market's low caused by the Great Recession. The Dow Jones Industrial Average hit a low of 6,547 on March 9, 2009. If an investor had done nothing for the next 10 years, the Dow Jones Industrial Average would have produced an annualized total return of approximately 17.2%.

While most investors would prefer to forget the events of 2008 and 2009, it is instructive to look back and see what went wrong and perhaps how some of the damage could have been avoided. It is also interesting to assess whether or not market conditions today are vulnerable to some of the same problems we experienced 10 years ago. Recessions are a normal occurrence in the business cycle. Typically, they last 6 to 12 months and oftentimes they are caused by the Federal Reserve raising interest rates too much or too quickly. Sometimes they are caused by unpredictable events like the September 11, 2001 attack or the earthquake and tsunami that caused a nuclear powerplant meltdown in Japan. We believe that the severity of the Great Recession was driven by fears that the global banking system would literally melt down. Foolish investment banks like Bear Stearns, Lehman Brothers, Goldman Sachs and many others, invested in exotic financial instruments that packaged together a mixture of toxic real estate loans that never were likely to be paid back. To make matters worse, these banks borrowed vast amounts of money which dramatically magnified the risks. Some banks had only 2% or 3% equity as a buffer in case something went wrong. Trading losses in the risky securities caused enormous losses at Citibank, Bank of America, J.P. Morgan and many others. A number of smaller, regional and community banks also got caught up in the hysteria and suffered large, and in some cases, terminal losses with subprime lending and poorly conceived mortgage loans. The result was a severe recession where unemployment eventually hit 10% and the global economy was severely damaged.

Fast forward to current times and we find banks and financial institutions here in the U.S. in strong financial shape. Some very good regulatory requirements for banks and other financial institutions have required U.S. banks to greatly increase their equity reserves. They have also been effectively limited in how much overall risk they can take in their investment portfolios. While these regulations are good for America and the safety of the banking system, they come at a large price to the banking industry which will be significantly less profitable going forward. It is interesting to note that while the U.S. financial system is very secure, many European and other foreign banks are, in our opinion, not secure. Leading the pack would be the largest bank in Europe, Deutsche Bank, followed by troubled institutions in Italy, Spain and elsewhere. This alone is a good reason to limit investments in European businesses.

As investors, the lessons of the Great Recession include the importance of having an appropriate asset allocation and reasonable diversification. It also points out the importance of rebalancing. For us, it emphasizes one of the key factors that has been central to our firm's investment style throughout its 40-year history, and that is to buy very high quality companies with small or moderate debt burdens.

One thing the markets do not seem to have learned fully is the risk of overpaying for businesses that appear to have almost unlimited growth potential. This phenomenon has been present in financial markets since the tulip bulb craze in Holland in the mid-1600s. Today, we see many technology companies valued at extremely high levels and we see a variety of new economy companies that are changing the world but are not profitable and are unlikely to become profitable anytime soon.

The last area where many investors have learned a lesson is to be wary of government at all levels. The Federal Reserve cut interest rates to 0% quickly to avoid the recession becoming even worse. We think the Fed did a great job in the first few years after the crisis, but it has kept rates at very low levels for a very long time. This has punished investors who own bonds and CDs and have received almost no interest. Today, a 6-month treasury bill yields 2.4% and a 10-year treasury pays 2.75%. We believe inflation is running about 2% and most investors have to pay tax on the interest they receive. Even today, they are not earning much after inflation and taxes. This is why we are watching political developments very closely. Many of the recent proposals sound wonderful, such as Medicare for all, free college tuition, a guaranteed annual income from the government (even if you do not want to work) along with unlimited renewable energy, creating high paying jobs for all. The sad fact is that these wonderful programs are thoroughly and completely unaffordable.

One of the things that almost no one has paid attention to over the last 10 years is the U.S. federal debt. When George W. Bush arrived at the White House, the U.S. had accumulated a total debt burden of $5 trillion. By the time he left, that amount had doubled to $10 trillion. When President Obama left, the figure had ballooned to $20 trillion, and today it stands north of $22 trillion. In 18 years, the debt has gone from $5 trillion to $22 trillion. It should be obvious that the country is nowhere near able to afford its current programs, let alone all the great new ideas. We are not attacking progressives, nor supporting conservatives. We merely wish to point out that the U.S. government is not able to live within its means currently, and it simply cannot afford ambitious new programs.

Here are the takeaways from our look back on the great recession. First, the world did not come to an end and, as it always has in the past, the financial markets recovered and have enjoyed years of strong returns. Once again, we see that the U.S. has led the world out of this economic mess. The U.S. economy is broad, diversified and strong. The U.S. leads the world in higher education and technology creation and utilization. While our governance faces many challenges and causes us all many frustrations, it is a lot better than almost any other government on the planet. This is why we invest the vast majority of our clients' funds in U.S. based companies. Our economy is strong today and corporate earnings should be able to show sustainable growth this year and next. We believe that stocks are fairly priced and therefore a good place to invest at this time.

Best regards,

Harry Papp

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Managing Partner
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