Capital & Crisis

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By Way of an Introduction

Booms, Busts and the Big Lie

Given the immense number of newsletters available to the contemporary financial observer, it may reasonably be wondered as to why we need yet another. The short answer is because contrarian analysis and uncommon ideas are always in short supply against the mythmaking of mainstream commonplace thinking.

Capital & Crisis is written from a contrarian perspective. The essence of contrarian thinking is that an unquestioned consensus foreshadows some impending error. Or, as Humphrey Neill memorably put it, "when everyone thinks alike, everyone is likely to be wrong."[1]

"Everyone" in Wall Street parlance usually means derisively "the crowd" or "the herd". Market lore is replete with tales of the madness of crowds and the follies of following the herd. Most people like to think they are not part of the multitude, and yet by definition, most people are. Contrary thinking is a self-limiting proposition. I always think back to the old riddle that asks how far a dog can run into the woods. The answer is halfway. After that, he's running out.

As this is written on the backside of the greatest financial bubble in American history, gazing back at a peak that looks more magnificent with the passage of time, we have plenty of fresh evidence on why contrary thinking is good for the portfolio and good for the soul. Contrary thinking in early 2000 would have saved you a lot of money. But, that is the nature of markets. Booming markets foster illusion; bear markets pull back the curtains.

Contrary thinking helps pull back that curtain before the crowd does – before it's too late. What everyone knows is not worth knowing, as the old saw goes.

[1] Humphrey Neill, *The Art of Contrary Thinking* (Caxton Printers, 1992), p. 1.

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Editor

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Yet, the crowd is not *always* wrong. The great myth about contrarian thinking is that it consists of simply betting against the crowd. The art of successful contrary thinking is in its astute application. The last boom was a particularly fertile occasion for contrary thought.

The great boom of the late 20th century was built on a lie. In retrospect, it is easier to see. Broadly speaking, it was simply that we can get something for nothing or that a new era had repealed the old laws of economics. In this aspect, the lie was probably as old as the oldest of human civilizations, told repeatedly over thousands of years. The late 20th century American bubble was perhaps novel in its size, scope and sheer ambition.

Under this big tent thrived a circus of bad ideas – that paper was wealth; that the art of central banking had advanced such that it had eliminated the business cycle, or that technology had; that stocks were thought less risky than bonds (and the concept of risk was thus warped beyond recognition or usefulness); that stocks were always a good investment; that investment returns were not the just reward for the skillful deployment of capital, but a near political right deserved by all.

All of these and more have their counterparts in the bubbles and booms of the past. There are new twists and variations on the theme, of course. Each historical episode is by nature a unique human experience, forever buried in the flux of time. Nonetheless, in its essentials, the late 20th century boom had all the familiar markings of its siblings and cousins.

The reader may sensibly wonder what this has to do with our masthead. I believe that the starting point for understanding the phenomenon of the boom and bust is to understand the notion of capital and in particular the nexus between capital, money and interest rates. Like the threads of a spider's silvery web, a pull or a tug on one thread sends telling vibrations throughout. The consequences of tinkering with any one is to upset all three. As a result, money and capital are often confused for each other, and low interest rates are viewed as a laudatory policy goal or achievement. The consequences, however unintended, are ignored. The important distinctions and roles each of these concepts plays in a market economy are often neglected.

This foggy view of capital results in repeated episodes of crisis**.** Capital and crisis, the latter ending the prosperity of the former, are forever linked together, as with Capone and Ness, or Hannibal and Scipio.

The whole of the economy is a complex latticework of varied capital. Like a fine wine, it is not easily replaced. Lost capital requires additional time and work to replace. Capital is lost naturally, as it is used in production or research, for example, or it can be lost when it is not invested in a profitable manner. In the natural workings of a market economy, unprofitable investment will occur because human beings are fallible and the future is unknown. The boom and bust, though, goes well beyond this.

Wide-scale *malinvestment*, or investing of capital in what later proves to be an unprofitable manner, is the defining characteristic of booms, caused by a disruption in that nexus between capital, money and interest rates. Crisis is the result of that later inevitable reckoning when such booms are found to be unsustainable.

This boom and bust cycle is endlessly fascinating and instructive. *Capital & Crisis* is written for those connoisseurs of financial panics, manias, booms, busts and crises of all sorts. These events will all get ample space in these pages. Their causes and consequences, and their implications for investors will be explored.

This monthly journal will not have all the answers, but it will – in Socratic fashion – fearlessly question consensus opinion. In doing this alone, *Capital & Crisis* will distinguish itself in a crowded field.

Our beat will be limited to things financial - the stock market, the bond market, and the economy in general. These letters will deal with its history, it present state and its prospective future. To the extent that your editor stumbles on potentially profitable opportunities, they will be presented in due course.

Also, your editor must confess to certain peculiarities and idiosyncrasies. For one, I am an avid reader of the so-called Austrians, pre-eminently among these are Ludwig von Mises and Murray Rothbard. For another, I have an unusual fondness for old books, old ideas and old investors. Insights from these sources will inevitably be brought to light in these pages and so, the reader is forewarned. The ideas themselves are not likely to be wholly original, but then again, as Freeman Tilden warned "original thinking is often more praiseworthy in purpose than accurate in result."[2]

You are cordially invited to subscribe. At $48 per year, or four bucks an issue, the price is also a distinguishing feature in a field where subscription costs routinely top $200 per year. *Capital & Crisis* is a cheap antidote to the commonplace in thinking.

[2] Freeman Tilden, *A World in Debt* (1983 reprint), p. 10.

The Mortgage-Stones of America

In the rubble of post-bubble America, what do you do with the piles of debt that have been accumulated in the preceding boom? Normally, you might sweat if off, as you might work off a big meal. Recessions and busts are usually what do this, but this last downturn seems to have been mild and its work not yet finished.

The current federal debt outstanding according to the Bureau of Public Debt stands at $6.9 trillion.[3] The public debt has risen without interruption since 1956.[4]

Consumers are no better off. Consumers have kept on borrowing and spending through the bust. Household balance sheets don't appear very sturdy. As quoted in a recent newspaper column, the ratio of household liabilities to net worth hit an all-time high of 22.6 percent in the first quarter of 2003 (the most recent data available). Outstanding consumer credit, mortgage debt and other debt hit $9.3 trillion by April 2003: "A lot of people are dangerously close to the edge and any minor setback could push them over," said Amelia Warren Tygai, co-author of *The Two-Income Trap: Why Middle-Class Mothers and Fathers are Going Broke*".[5]

Given the large amount of debt outstanding, it is easy to see that creditors are not likely to win any votes in deciding the future monetary policy of the country. Repudiation of debt is the familiar song in history, the favored path used to extinguish debt. It seems likely that it will be no different this time.

Ever since the creation of money, there have been numerous attempts to cheat it – coin clipping, devaluation, confiscation of gold, etc. These are the recurring patterns of theft that wind through financial history as winters follow autumns.

Statecraft learned the art of repudiation a long time ago, at least at early as Solon, the lawgiver of Athens in 7th-6th centuries BC. Thomas Cahill, in his latest book, called Solon "a sort of Athenian Franklin D. Roosevelt."[6] Indeed, both men led famous repudiations on the citizens they governed.

It was Solon, according to the historian Plutarch (AD c. 46 – c. 120) who lightened the debt burdens of Athenians by "raising the value of their money; for he made a pound, which before had passed for seventy-three drachmas, go for a hundred; so that, though the number of pieces in the payment was equal, the value was less; which proved a considerable benefit to those that were to discharge debts."

In fine Athenian fashion, and very much like our own modern age, such a treacherous act was given a pretty name. This was "softening the badness of a thing," as Plutarch called it, where harlots were mistresses and tributes were customs and a jail became a chamber. In any event, the Greeks called Solon's act a *seisacthea*, meaning a relief or a disencumberance.

Thus, Plutarch cites a poem, credited to Solon where he "takes honor to himself that" - "The mortgage-stones that covered her [Athens], by me, removed, - the land that was a slave is free…"[7]

Solon forced a revaluation, in effect transferring wealth from creditors to debtors.

Freeman Tilden commenting on this episode noted that the mortgage stones would reappear again through the centuries. He writes that "if the repudiation of contract, including the remission or lightening of debts contrary to the bond, were the open-sesame to perfect justice and prosperity, the gods would have come down from Olympus and jointed the human race long ago. The experiment is not novel."[8]

It was probably not Cahill's intent, but his linking Solon with FDR is most apropos in this respect, because FDR too pursued a similar policy of debt relief in the 1930s – by breaking contracts.

Faced with paying for the extravagance of the New Deal and also grappling with a severe crisis, Roosevelt chose the tried old hand of repudiation. (Note, we call it the "New Deal" when in fact it was basically "Old World Socialism," more "softening the badness of a thing.")

[3] Current public debt statistics are available at http://www.publicdebt.treas.gov/opd/opd.htm]

[4] See *The Dollar Crisis*, by Richard Duncan, for more on this.

[5] "Easy credit, temptations lure many to the edge" by Susan Tompor available at www.freep.com/money/business.

[6] Thomas Cahill, *Sailing the Wine-Dark Sea* (Doubleday, 2003).

[7] One can read the whole chapter on Solon at: www.pinkmonkey.com/dl/library1/solon.pdf

[8] *A World in Debt* (1983 reprint) by Freeman Tilden, p. 106.

In 1933, the incoming Roosevelt administration assaulted the monetary order of the country. The country went off the old gold standard. The government confiscated the gold of American citizens and put it under the ownership of the Federal Reserve. They placed an embargo on the export of gold. And, they devalued the dollar to $35 an ounce, where once an ounce of gold could be had for about $20. Interesting that the man who supposedly saved capitalism pounced on it like a lion on a wounded gazelle.

The Roosevelt administration also brazenly stepped in and repudiated private and public contracts that required payment in gold. In other words, it had been customary for contracts to have gold clauses requiring payment in gold and protecting the creditor. Roosevelt said that this was no longer legal and that if you had signed a contract stating that you promised to pay in gold, you no longer had to do so. A promise was not a promise anymore. And so, we see the truth of Emerson, who observed that the study of economics often mixes itself with morals.

The anti-New Dealers, a spirited group still clinging to simple morals and personal liberty, fought the Roosevelt administration every step of the way. History would later show that they were on the wrong side of history and they are, for the most part, written out of mainstream histories of the period. The victors do write history, after all.

This group was dealt another blow when the Supreme Court upheld the government's repudiation of private and public contracts to pay in gold, by the slimmest of majorities, 5-4. The court reasoned that these contracts interfered with the government's ability to control the supply of money – which they did and which was precisely the point.

These actions were consistent with the goals of the New Deal. As economist Benjamin M. Anderson noted "the New Deal tax policy from the beginning has been more concerned with the redistribution of wealth than with raising revenue."[9] All of these schemes simply robbed creditors and handed the gains to debtors.

Creditors are not likely to gain sympathy in the public mind, but consider this: Who are the creditors? As Henry Hazlitt observed, "A poor man never gets to be a big debtor."[10]

The masses of creditors are simple savers, mostly regular working people, who sock away money in the bank. The debtors are mostly the government and people that have money and property to pledge as collateral. (With the advent of credit cards and the emergence of a highly developed mortgage market, our modern age may differ in this respect – debtors of today don't have to have much at all to carry significant wads of credit card debt and an overleveraged house.)

With all the debt still saddled on the US, it is an irony that the rising stock market and happy statistics have given most Americans the hope that things have turned and the boom is on. But what sort of prosperity is this?

The following Albert Jay Nock quotation is astounding for its relevance today. Commenting in the 1930s, Nock wrote, "Reports seem to show the regular pre-election effort to start a boom in the stock market is on. Americans have a strange notion that the ordinary laws of economics do not apply to them. So doubtless they will think they are prosperous if the boom starts, and that deficits and indebtedness are merely signs of how prosperous they are."[11]

How uncanny is that? How easily could that paragraph be lifted and put in today's *Wall Street Journal*?

The repeated repudiations found throughout history led Tilden to conclude "at least half of all economic history is concerned with the tragi-comedy of governments getting into debt by extravagance and trying to get out by fraud." Though, he would wisely add, "the other half is concerned with individuals attempting to do the same thing."[12]

The forces that led to these earlier repudiations and swindles are converging now on a debt-laden America. From Solon, to Roosevelt, to Nixon's closing of the gold window, that is the path most often chosen. The modern method of repudiation or debt relief is through inflation. This technique allows the repayment of debts with depreciated dollars. All you need is a printing press. My guess is that Bernanke's printing press will be busy.

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[9] *Economics and the Public Welfare* (Liberty Fund, 1979), p. 365.
[10] From the Introduction to Andrew Dickson White's *Fiat Money Inflation in France* (Foundation for Economic Education, 1959), p. 14.
[11] Albert Jay Nock, *Cogitations* (The Nockian Society, 1985), p. 29.
[12] Tilden, p. 107.

The Dreaded "D" Word

However, there is inflation's unloved sister, the odious deflation. For that, we turn to an interesting paper by professor Joseph Salerno titled "Two Cheers for Deflationary Monetary Policy," written in July.[13] Salerno is the clearest thinker on the issue of deflation today, a subject which elicits more fear than reason. The good professor also wrote another earlier paper on deflation called "An Austrian Taxonomy of Deflation" (also available at Mises.org, your editor commented on this piece in a Mises.org essay titled "The Imaginary Evils of Inflation"). The taxonomy Salerno presented clearly delineated the various kinds of deflation and exploded the myth that deflation is coincident with financial disaster.

In his latest paper, Salerno goes a step further and looks at a deliberately engineered *fiscal deflation*. That is, a policy whereby a central bank actively works to contract the supply of money and credit (for example, by raising reserve requirements and/or running treasury surpluses to extinguish debt).

This should not strike one as so far-fetched, as Salerno notes it has succeeded historically, for example, in Great Britain after the Napoleonic Wars and in the US after the Civil War. Salerno offers a more detailed look at the depression in 1920-21 in the US.

The 1920-21 bust came on the heels of a boom that started around 1915 and lasted for five years. During this time, money supply (M2) increased at an average annual rate of 15.5%, according to Salerno, which was also characterized by similar increases in prices.

The Fed, however, started to work actively in curbing the inflationary boom by steadily raising the discount rate. A sharp contraction in money growth followed, with a 7.5% decline in 1921. The GDP deflator, Salerno reports, fell 16.6% in 1921, the CPI fell 10.9% and wholesale prices plummeted 36.8%. Wage rates also fell 11% over the two-year period 1920-21 for non-agricultural workers.

And yet, the economy began to recover in August 1921, merely 18 months after the depression began. Salerno writes "Modern commentators on the 1920-21 Depression, to the extent that they have taken note of it, tend to be surprised by its brevity, given the sharp, policy-inducted deflation that accompanied it and the extreme reluctance of political and monetary authorities to undertake stimulatory measures to mitigate its severity."

This episode was not so unusual under a gold standard. As Salerno writes, the central bank "would on occasion deliberately engineer bank credit deflation in order to avert or mitigate impending financial crises provoked by its previous inflationary policy."

The previous inflation, having multiplied money and credit beyond what could be supported by the underlying gold stock, was corrected by the subsequent deflation. The deflation brought money and gold back in balance. It did not tend to create new burdens or malinvestments, as inflationary booms do, but rather brought the monetary stock closer to representing the true capital stock of the country. It was curative, in this respect and not pathological.

Given that deflation is often viewed as an unmitigated evil and yet also keeping in mind the historical reality, it is interesting to consider the arguments for deflationary monetary policy in a pure fiat currency system.

Contractionary monetary policy leads to a decline in money supply, an increase in the purchasing power of money, and a general fall in prices. This should not pose any particular problem as long as prices are free to adjust, including wage rates, without political interference. Any attempt to prevent certain prices from falling to meet the new reality would lead to disaster.

Salerno points out, relying on arguments made by Hayek, that monetary inflation is far more dangerous over the long-term than deflation. For one thing, political and psychological factors make it the far more likely scenario. Quoting Hayek:

> "The reason for this is that moderate inflation is generally pleasant while it proceeds whereas deflation is immediately and acutely painful…The difference between inflation and deflation is that, with the former, the pleasant surprise comes first and the reaction later, while with the latter, the first effect on business is depressing."

These political and psychological factors make current fears of deflation "completely groundless" in Professor Salerno's view.

Also, inflation can lead to hyperinflation and a total breakdown of the monetary order. Inflation, as noted previously, is a redistribution of wealth from creditor to

[13] The paper is available free of charge at www.Mises.org.

debtor, from those who receive the newly inflated purchasing power first against those that receive it later.

We don't always have to look at it in terms of extremes either. As Salerno observes a 3% annual contraction in the money supply should pose no more of a problem than a 3% annual increase in the money supply, so often advocated by monetarists.

Deflation is one way, though perhaps not the best way (as Salerno acknowledges) of moving back to 100% backed commodity money.

Another important idea discussed is the differing welfare effects of inflation against those of deflation. It is common in economic texts to use the term *seignorage* to denote the so-called inflation tax or the loss on money holders when revenue is raised through the printing of money.

While deflationary welfare effects are quite different, and have been recognized by economists, it has generally not been elaborated upon or named. Salerno gives us the term *rabattage* "which signifies a diminution or abatement". As opposed to seignorage, the rabattage effect favors taxpayers and money holders against net tax consumers and debtors. The effect also suppresses the malinvestments characteristic of inflationary booms.

In summary, Salerno writes:

> "Whereas inflationary finance never moves us closer to a commodity money and risks hyperinflation and the abolition of money in the bargain should the State's hunger for seignorage revenues exceed certain bounds, fiscal deflation, if carried out properly, conceivably moves the fiat monetary regime back toward its original roots in a market commodity."

Doubtless, any talk of deflation being a benign phenomenon is going to be wrought with controversy. And any attempt to actively create deflation is likely to be met with outright hostility. The political environment probably does not allow the freely floating prices that would be required to pull off a fiscal deflation, not to mention the crushing effect on our massive debtors.

Still, Salerno's work continues to shed important light on the nature of deflation and improve our theoretical and historical understanding of it. Also, in fine contrarian fashion, it challenges the assumptions made by mainstream economists and allays fears that deflation necessarily is a disaster.

Inflation: Something Wicked This Way Comes

The title of this piece is somewhat deceptive. Inflation proper (an expansion in money supply) has been going on for quite awhile. It was the fuel for the late nineties boom. What we are talking about might be more accurately described as price inflation – a general and widespread increase in prices, or, stated differently, a general and widespread decline in the purchasing power of money. In the dollar's decline, we have started to see this, but that is only the beginning.

Bill Gross of PIMCO, the Warren Buffett of the bond world, has long been an astute observer of the bond market, and financial markets generally. His December 2003 Investment Outlook[14] contained a nice summation of an investment thesis for 2004. In short, Gross is in the inflation camp, as is your editor.

Gross seems to take Fed officials for their word when they talk about "printing presses". Wisely, in my estimation. There are few things government cudgels do with much skill, but one of them is certainly destroying the value of their own currencies. History gives us plenty of examples, most famously the great German hyperinflation of the early 1920s or France in the 1790s. But there are recent examples too, especially in Latin America and the old Soviet bloc countries. All paper monetary systems tend toward the valueless and crisis-ridden, as history proves (more on this next month).

In Gross's view, the reflationary effort is only in its infancy and it is not likely to immediately jump up and bite investors. [Note, reflation is the somewhat contrived term often used to describe an attempt to revive a previous inflationary boom by increasing or stepping up inflation] Nonetheless, the stance for investors today should be one of preparing for increasingly wicked inflation.

Gross presents the following asset categories, which he ranks by his own personal preference. These include commodities and tangible assets, foreign currencies, real estate, TIPS (which can now easily be bought and traded on the NYSE, ticker TIP), and global bonds and equities denominated in non-dollar currencies. Gross calls these reflatables and if you are shopping for places to put your money, this list would be a good place to start.

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[14] The Outlook column for December 2003 can be found at www.pimco.com.

Reflecting on his choices, in particular global bonds, Gross notes the likelihood that foreign currency gains will dominate returns, even if yields should move higher. Foreign credit markets present slightly higher yields to begin with, though one has to wrestle (sometimes) with estimating the additional political risk. Similarly global equities offer cheaper valuations than US equities. Gross notes that the UK's FTSE yields 3.7% compared to 1.6% for the S&P, as well as selling for lower P/E multiples.

To revisit Gross's point about foreign currency gains figuring more prominently in future returns; there is no doubt the dollar is weakening. Long held as the international currency of choice, it has been weakening for at lease a year and there are suggestions that it may be the beginning of a significant revaluation.

First, there is the simple raw evidence of market data. The dollar seems to make new lows against the euro every day; the dollar declined 20% against the euro in 2003. It also reached an eleven-year low against the pound and a ten-year low against the Canadian dollar. These are not isolated examples, but recurring strands of a larger fabric of soft comparisons against foreign currencies. From its peak in 2001, the U.S. dollar index, which charts the currency against a basket of six major foreign currencies, has declined more than 25%.

Another clue is found in the gold market. The yellow metal had a tremendous year in 2003 and now trades north of $400 per ounce – a level not seen in more than eight years and is up more than 25% from one year ago. Gold is up 50% from its low of $255 per ounce in 1999. Gold was the reserve currency of choice for centuries. Ever since the collapse of the Bretton Woods Agreement and Nixon's closing of the gold window in 1971, the dollar has no longer been defined in terms of gold ounces.

In addition to cold numbers, there is anecdotal evidence of interest. Warren Buffett, for one, is selling the dollar. In his article for *Fortune* ("Why I'm not buying the U.S. dollar")[15] Buffett writes, "Through the spring of 2002, I had lived nearly 72 years without purchasing a foreign currency. Since then Berkshire has made significant investments in – and today holds – several currencies. I won't give you the particulars; in fact, it is largely irrelevant which currencies they are. What does matter is the underlying point: To hold other currencies is to believe that the dollar will decline."

When the Oracle of Omaha does something he has never done before, that is worth noting.

Buffett cites primarily the unprecedented size of the U.S. balance of payments deficit. Foreigners hold $9 trillion worth of US dollar-denominated assets. Much of that is in US bonds. The accumulation of this debt has surpassed all previous records. Foreigners are not likely to continue buying dollars at record-setting levels and any shifting in this trend will result in a further weakening of the dollar.

Buffett is not alone – Soros, Templeton, Jim Rogers and other investment luminaries are betting on a dollar decline. That is not a crowd one is going to make a lot of money betting against.

With continued weakening of the dollar playing a significant part of the investment backdrop, investors find themselves in a tough spot. During the boom of 1995-1999 it was easy enough to refrain from buying tech stocks for example. The risks today seem more nebulous and far-reaching, and hedging seems more difficult. It is easy to understand the bullish case for reflatables, given the viewpoint described in these pages, it is more difficult finding concrete investment ideas that represent good values in these areas. Looking at commodities, for example, many gold companies seem expensive and lack Ben Graham's margin of safety. They have become speculations on the price of gold, a good speculation, perhaps, but a speculation nonetheless. Better to own the metal itself, at this point, but that is not easy to do.

Investors can widen their search and explore other tangible assets. But again, in most of these instances, the readily available and liquid investments are going to be in commodity-oriented companies that have their attendant risks and are not pure plays on the underlying commodities themselves. Real estate is similar, except that most people have real estate exposure with their investment in their own homes. Other types of real estate related assets deserve to be explored, too, and these include land companies and REITS.

A weakening dollar naturally implies that several (many?) foreign currencies will do better relative to the dollar. Hence, investments in non-dollar denominated foreign securities should do well relative to the dollar, all else being equal. The problem is that international investing (especially the emerging market variety) has its own risks, often overlooked, and foremost among these is political risk.

[15] The article is available at www.pbs.org/wsw/news/fortunearticle_20031026_03.html

For more on this, we turn to Marshall Auerback, Prudent Bear's man on the international scene. Auerback's November essay "The Return Of The Political Risk Premium" is highly recommended.[16] Highlighting a number of financial conflicts that have occurred around the world, Auerback wonders whether investors are properly discounting political risk. He sees "a broad trend back toward populist politics in the developing world, a type of politics far more inimical to western investment, thereby necessitating an inevitable elevation of political risk premiums. Higher political risk premiums mean higher economic costs both for the recipient countries and the western investing public. The investors' capital is at greater risk; his scope for international diversification is circumscribed as the "global" free market platform becomes a smaller island."

Auerback faults post-Cold War thinking that has oversold the extent to which globalization has occurred in financial markets. He questions the supposed triumphs of capitalism and democracy on the international stage. The consensus seems to view the international markets as simple extensions or "branch plants… rather than political basket cases worthy of discounted price/earnings ratios."

The truth is that international investing requires dealing with some unknowable political risks. I remember lessons learned from Murray Stahl, the fine contrarian essayist and investor at Horizon Management. In an essay titled, "An Unorthodox View of Emerging Market Investing," Stahl presents a vibrant economic picture of Hungary, noting many positive investment attributes, statistical and anecdotal in nature.[17] The reader is led to believe that Stahl is describing the Hungary of 1994, when in fact he is describing Hungary in 1894.

The point is to show that Hungary, actually a rather mature market in 1894 (which morphed into an emerging market in modern times), would have cost investors nearly all of their capital by 1914 – the start of World War I. Stahl concludes:

"The great bulk of modern thought concerning the principle of diversification is based on the belief that securities markets display predictable return patterns over multi-year time periods. Consequently, one can lower risk and increase return by diversification strategies based on rigorous scrutiny of historical data. This essay would only wish to suggest that future history is not predictable and that perhaps sometimes risk can be increased by emerging market investments in ways that it is impossible to know at the moment." The warning here is tread carefully in the hot emerging markets of the day.

In summary, the reflatables have a great deal of investment appeal at the theoretical level. Finding concrete ideas and opportunities that meet a rigorous test for a margin of safety is more difficult. That is always the more difficult task. It is easy to have a macro view (especially an ill-conceived one). Every bootblack and barber, so to speak, have an opinion on the big world around them. The hard work lies in the details of understanding specific companies and the securities they issue.

One of the greatest handbooks ever penned on the investment trade was written by a practitioner named Martin Whitman, who is currently the steady hand behind the Third Avenue Value Fund. His book, *Value Investing: A Balanced Approach*, reflects a philosophy grounded in real world considerations. It is balanced in the sense that "no *a priori* primacy is given to any one factor in an appraisal."[18] It focuses on what is safe and cheap. Market prices become something to take advantage of, rather than something to predict. It is rooted in present-day realities and probabilities, and is not dependent on skillful clairvoyance. Next month's issue will take a close look at Whitman, his fund, his approach and some good opportunities for favorable investment outcomes.

Capital & Crisis
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Christopher W. Mayer
Editor

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[16] Marshall Auerback, "The Return Of The Political Risk Premium", November 11, 2003, available at http://www.prudentbear.com.

[17] Murray Stahl, *Collected Commentaries and Conundrums Regarding Value Investing* (Horizon Asset Management, 1995).

[18] Martin J. Whitman, *Value Investing: A Balanced Approach* (John Wiley & Sons, 1999), p. 3.