

The Muhlenkamp Memorandum

Investing and Farming ☞ *Know the Climate* (Continued)

Then they learned that unless they watered the lawn every other day, it soon returned to sand. When they built a second house, they landscaped the yard in sand and rocks. In Albuquerque, brown--not green--is beautiful.

The climate for investing is heavily influenced by the levels of inflation and interest rates and can change fairly rapidly. In the 1970's, the investing climate in the U.S. was determined by inflation levels well above interest rates. You could not offset inflation by lending money. Anyone who had a savings account or bought bonds was a sure loser--and most paid taxes for the privilege. Rather than lending money, the climate favored borrowing money and buying "hard" assets like gold, oil and real estate that held their real value versus the depreciating (deflating) dollar. By the end of the decade, many people believed that prices of these assets could only go up. So they continued to borrow money to buy them. They borrowed money regardless of the rate, and so interest rates climbed.

But, while this was happening, inflation was being brought under control. Inflation fell while interest rates climbed. Since 1981, interest rates have been well above inflation reversing the investment climate of the '70's. Other influences (like tax laws) have reinforced this change in climate. So it has paid to lend money. Savings accounts, bonds and stocks have been big money makers. Owning gold or oil or mortgaged real estate has been very expensive--sort of like trying to grow cotton in Ohio or grass in Albuquerque.

The fundamental difference between farming and investing is that, in the aggregate, we the people determine the climate for investing. Inflation is determined by government action in response to our demands. Interest rates are determined directly by the levels which people are willing to pay or receive. Our unwillingness to pay directly for the Vietnam War in the mid-60's set off an inflationary spiral (and a change in climate) which lasted until inflation became intolerable to the average voter. Meanwhile, the public's awareness of inflation lagged the reality; so that throughout the '70's, the public accepted interest rates well below inflation. This came to a head in 1979-80 when the voting public insisted on lower inflation and higher interest rates☞ and changed the climate. People who bought gold, oil or farmland in the late '70's soon learned that the climate had changed. Those who did so with borrowed money lost on both sides. Their interest costs went up and the market and collateral values went down, and many lost their assets. Changes in tax laws and the regulatory rules for banks and savings & loans allowed professional lenders to deny the change in climate for a while, building ever more high cost commercial buildings. By 1986, the excesses became apparent even to our politicians. Once again, they changed the rules☞ just in time to compound the retrenchment in commercial real estate.

The remaining vestige of the '70's inflationary climate was the popular belief that a highly mortgaged single-family home would make you money. We've been discussing the fallacy of this belief in this newsletter since 1987. In the past year, the belief seems to have died. We cite as proof the public's focus on "paying down their mortgage" that reflects the current climate and is the direct opposite to "trading up on the equity" that was appropriate to the climate of the '70's.

This focus on paying down the mortgage along with the Fed's successful slowing of the economy has also resulted in short-term interest rates falling from their unusually high levels of the past decade. Since 1989 we have argued that high short-term rates were an anomaly, and could only be temporary. These rates have now fallen, and is forcing the savers in this country to face a broader choice of options in an effort to reach their goals. As they review these options, they will find the investing climate in the U.S. remains positive for stocks and bonds.

But even within a given climate, the seasonal and daily weather patterns have great variability. While Ohio planting done in April is less likely to suffer frost than that done in February, a late frost cannot be ruled out. The hot, humid weather of July and August, which is ideal for growing a corn crop, also makes ideal conditions for hailstorms. Seasonally speaking, the U.S. economy is now coming out of a recession, albeit following a couple of false starts. For the past couple years, our choice of cyclical stocks has focused on those with strong balance sheets. We wanted to be sure that the companies we invested in would survive and thrive even if the economic recovery was delayed, and some of their competitors failed. Just as any farmer who doesn't allow for a late frost or a hailstorm will soon be wiped out, we expected that the weaker companies in a number of cyclical industries might face extinction. As we see the economy strengthen, we may loosen these balance sheet standards.

The emotional swings of the investing public, which affect the daily price of securities, are at least as variable as the daily weather. These swings are part and parcel of all investing climates. They key is not to confuse the daily changes with seasonal changes or the climate! I've often compared the October 1987 stock market crash, which dropped prices 25% in two days, to a hailstorm which wiped out one year's crop. But it didn't change the climate nor the fertility of the soil (the strength of the real economy). So the appropriate response was to plant a new crop. And 1988 produced a bumper crop. 1990 was a poor year. The Mideast problem became a war and resulted in both scaring the public (bad weather in our analogy) and postponing the end of the recession (a delayed spring). But it also set the stage for a bumper crop in the following year. We don't expect such a bumper crop this year, but we do expect an average year because the climate remains favorable and spring is here.