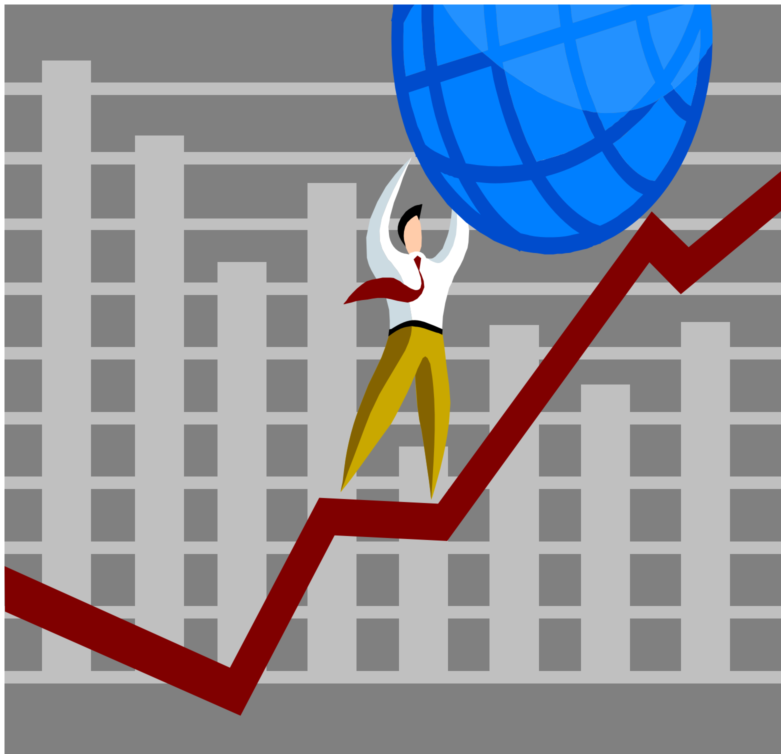
Weyland Capital Management LLC

Research

Hey, who took the punch bowl?!?

2006 Q2 Quarterly Commentary



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Hey, who took the punch bowl?!?

William McChesney Martin, Jr. was the Federal Reserve Chairman from 1951 through 1970. He was selected to be Fed Chairman by Harry Truman who wanted the Federal Reserve Bank to become less independent and more sensitive to the political will of the White House than it had been theretofore. Harry thought that he had the right man for the job in Martin. Unfortunately for Harry, but fortunate for the generations since, Martin turned out to be a fierce advocate for Fed independence and a brilliant manager of the economy.

Today, Federal Reserve independence survives and that independence ensures that the tweaks and tuning of the business cycle that the Fed performs is for the singular purpose of improving the long-term functioning of the economy. Sometimes their actions may be unpopular and sometimes they may get it wrong, but we can have faith in that they are doing the things they are doing in order to improve our lot.

But I bring up William McChesney Martin not because of how he strengthened or refined the Fed, but because of a comment that he made repeatedly during his tenure that summarizes one duty of the Fed. It was he who stated that:

"The job of the Federal Reserve is to take away the punch bowl just when the party starts getting interesting."

Well, in the last weekend of April new Fed Chairman Ben Bernanke tried to take the punch bowl away as skillfully as he could, but ended up spilling some on himself, and on the markets. His cocktail chatter with CNBC anchorwoman Maria Bartiromo at some shindig was not only sophomoric, but contradicted his earlier testimony to Congress. As they say, not an auspicious start.

Perfect Storm

Unfortunately at the same time, and this has received little notice in the press, the Japanese were massively reducing liquidity. Think of this as Japan calling in lots and lots of loans that it had made previously. The combination of the Fed misstep and the aggressiveness of the Japanese action hit global markets hard. (Recently it was reported in the Wall Street Journal that a leading hedge fund lost 30% of its value in May alone. Ouch.)

No relief in geopolitics I'm afraid either. The situation in the Middle East (Israel, Iran, Hezbollah, Iraq, etc.) and the Horn of Africa (Somalia, Eritrea and Ethiopia) is showing signs of becoming truly unhinged. Domestically, we're going into an election season with the electorate more divided than any time since the Vietnamese War (more divided than during the Vietnamese War if you believe the New York Times). If these scenarios turn even uglier, it will increase what economists call the "risk premium" or the amount of money investors require to take risk – or in other words, higher risk-premiums means lower prices.

In order to gauge the markets, Frank and I use a number of fundamental value models and mathematical models. (For the technically inclined: we use rolling correlation, rolling momentum, rolling beta models, not to mention simple price models like moving averages. We examine absolute valuations within asset classes as well as relative valuations across asset classes.)

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We use these indicators like a doctor uses an MRI or blood tests in order to figure out how healthy the markets are. What we are finding right now is that the risk of the business cycle turning into a global recession is increasing – but not certain. The end of business cycles (where we conceivably are today) are typically higher risk – lower return environments. Keep in mind, however, that equity valuations are not crazy high like they were in 2000-2002. So although we see risk in the markets, we don't see an extended bear market.

Another concern for us is the recent increase in correlations among asset classes. This means that nearly all asset classes are in lock step – or, when one goes up, they all go up. Or worse, when one goes down, they all go down. This increase in correlation is not welcome as it temporarily but most definitely reduces the benefit of diversification.

So in order to reduce the risk in our portfolios for a potentially bumpy ride over the coming months, we have rebalanced our portfolios in July for the first time in over two years, reducing exposure to riskier asset classes. Additionally, since equities and commodities have outperformed bonds by so much over the past two years, their respective weightings in our portfolios had risen. Rebalancing seemed prudent.

At this time our posture is not defensive, just balanced. However, if the probability of systemic risk in the markets goes up, we will take defensive action to preserve our capital for the profitable beginning of the next business cycle.

In the meantime, quality assets like large cap equities (think: Big Company Stocks, Blue Chips) as well as our short-term bond positions should afford us some relief. I'd also like to add that we are not worried, just circumspect.

Performance and Tax Implications

A bit over a year ago in our Q1 2005 commentary "Ground Game", I wrote:

For this business cycle, we probably have entered the mid-to-late-stage, a stage that is characterized by continued choppiness but one that can be reasonably rewarding as well. Using a football analogy, we're in a ground game now, grinding out returns and protecting ourselves until we can see the emergence of the next business cycle.

Fortunately for us the past year has been more than "reasonably rewarding." We have included a year over year performance analysis in this report to give you an idea of the returns that we have been able to "grind out" during this aging business cycle.

Overall we beat over 99% of the balanced mutual funds in the U.S over this time period. FYI, when you review your year over year report, keep in mind that the the average balanced fund returned 6.0% over the past year.

Also in the Q1 2005 commentary I noted:

Over the past six years our portfolios have been tax efficient - meaning they have not spun-off many taxable gains requiring payments to the IRS. This is good as it allows our clients to keep more of their return…

Until the emergence of the next business cycle, we will probably have to realize more gains in our taxable portfolios as the markets' choppiness will lead to the need for more frequent rebalancing. Although the increased tax-bite will be less attractive, capturing returns and reducing volatility should be worth the cost. Naturally, we will strive to perform such rebalancing and harvesting of gains in the least invasive manner possible.

This has also come to pass, as the rebalancing that we have performed will naturally result in taxable gains this year. However, we continue to believe that capturing returns and reducing volatility ARE worth the cost. More importantly, once the next business cycle does kick-off, another protracted period of tax-efficiency will begin.

From the Trading Floor

Over the past two months we have had some pretty stressful days here as markets swooned and geopolitical events erupted. I'd like to give you a picture of how Frank and I work. We both sit in a 15x20 foot bullpen that overlooks the Piscataqua River. In it we have (just for us) five computers, seven monitors, four phones and a TV. We share a common desk and at no time are we farther than six feet from one another. This closeness yields a real-time collaboration that is both stimulating and fruitful.

I consider myself very fortunate to be able to work with Frank. He has an MBA, but those are a dime a dozen in my book. I do consider myself fortunate that he earned his MBA at University of Chicago, the best finance graduate school in America in my (and many others') opinion. I am also fortunate that he is a Chartered Financial Analyst, the most rigorous professional accreditation in the industry. Moreover, that he successfully managed a major university's endowment – well that's cake.

The bottom line here is that you have Frank and I working pretty much 24/7 ensuring your financial objectives will be realized. Our only job, our only business is managing your money. We don't take this responsibility lightly and we greatly appreciate the trust that you put in us.

Bob Henkel
Chief Investment Officer

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