

Questions of Character

By Michael Lewitt, Editor, The Credit Strategist
March 27, 2012

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This essay is excerpted from a recent version of The Credit Strategist (formerly the HCM Market Letter). To obtain the complete issue, you must subscribe directly to this publication; Please go [here](#). The Credit Strategist is on Twitter - @credstrategist



“Watch your thoughts, for they become words. Watch your words, for they become actions. Watch your actions, for they become... habits. Watch your habits, for they become your character. And watch your character, for it becomes your destiny! What we think we become.”

Margaret Thatcher (from her father)

“Character is what we a person does when nobody is looking.”

Ron Baron

There was a recent essay in **Forbes** by Jerry Bowyer entitled “Systemic Risk Is About Character” (February 27, 2011, p. 30) that made some valuable points about the responsibilities every participant in the financial system should be thinking about as he or she conducts his or her business. Financial risk, Mr. Bowyer argues, is created by the values that drive human behavior, not by exogenous events. Human beings, companies, and societies as a whole are responsible for creating risk through their own conduct: “[r]isk is not event-driven; risk is character driven.”

The issue of character colors everything. It is at the center of the presidential election that is unfolding in front of our horrified eyes as candidates alternately bore and appall us by either repeating or changing their positions. Character is what is missing from the halls of Congress, where the Senate has failed to pass a budget in more than 1,000 days and legislation is held captive by special interests that barely even pretend anymore to place principle above their selfish interests.

On Wall Street, a lack of character allowed the business practices that led to the 2008 financial crisis to flourish without being questioned. And it is a lack of courage to speak the truth to power that leaves the system vulnerable to the risks still posed by leverage, derivatives, rehypothecation and other obviously dangerous practices. Finally, to address a topic receiving more attention that it deserves because it should have been fixed a long time ago, the debate over the carried interest tax speaks to a lack of character among our



business and political leaders. Why is it only now that so many are unwilling to say to the Steven Schwarzmans of the world that their work is unworthy of a special tax break, that they insult our intelligence by marching up to Capitol Hill claiming they will stop taking risks if they have to pay the same tax rate as school teachers on the fruits of their labor when they have not been taking any meaningful risks at all?

As a long-time investor in leveraged companies, the character of management has long informed my decisions of where to direct capital. There is no margin of safety when you invest in a company managed by dishonest or reckless managers, or a management team that has a history of placing its own interests before those of its shareholders or creditors. The same is true of choosing an investment manager. Personal integrity is without question the most important quality required of an investment manager; if you invest with a man or woman of low character, you are placing your capital at great risk. The way an investment manager manages his own affairs and those of his firm and how he treats his employees and his family is the best indication of how he is going to handle your money. That is why it is important that people get to know – really know – their managers before they hire them. Character is more valuable than intelligence in choosing someone to shepherd your capital.

Too much complacency?

I rarely publish mid-month issues unless the financial markets are in the midst of crisis, and markets are decidedly not in crisis today. But like many diseases that silently attack the human body and only kill it years later, there are a number of forces eating away at the U.S. and global economy that threaten capital. The primary force is the incessant money creation that has become virtually the sole *raison d'être* of central bankers around the world. To the extent these public servants are exercising the creative sides of their brains, they are doing so only to develop new ways of injecting liquidity into the global financial system.

The world's four largest central banks – the Federal Reserve, European Central Bank (ECB), Bank of England and Bank of Japan - have stretched their balance sheets from \$3.65 trillion at the time Lehman Brothers failed to over \$9 trillion today (add in the central banks of China and Switzerland and the total rose from \$7.23 trillion to \$13.2 trillion over that period). By the time the current easing cycle is finished, it would be reasonable to expect total assets on the big four balance sheets to exceed \$12 trillion without a commensurate increase in economic growth in the underlying economies. The total debt of Europe's central banks (the ECB plus the national central banks) is now \$5.7 trillion, with the ECB's composite balance sheet doubling in size over the past six months. That is some serious monetary tumescence.

While there has been a definite need for economic stimulus, at some point the child has to be left to grow up on its own. Moreover, there are different parenting techniques that would allow the child to develop some of the skills it needs to move forward without parental help.



For example, the U.S. cries out for a tax policy that would direct capital to productive uses, while Europe could use a dose of labor and tax reform. Economic policy today is far too unbalanced in favor of monetary solutions to fiscal problems. There are actually a number of important economists and market commentators expressing these views, but policymakers are clinging to the monetary switches.

In the U.S., we have heard woefully little from either side of the campaign aisle in the way of genuinely exciting and creative pro-growth ideas. The weight of the election is crushing political and economic leadership at the cost of delaying much-needed reforms. Continuing the theme with which this issue began, the United States is living through the nightmare of investing its hopes in politicians who place their own re-election prospects ahead of serious policy reforms. President Obama's latest budget is an example of this. It is a testament to his skills as a thespian that the president can get up in front of a crowd and present his budget as a serious effort to promote economic growth and tax reform. I feel genuinely sorry for Jacob Lew and others on the president's staff charged with defending this document in public. Rather than make a serious proposal with genuine and realistic provisions for tax reform and economic growth, the budget is a concatenation of election slogans slung together into an incoherent mess that would destroy economic growth but for the fact that it doesn't have a chance in holy hell of passing.

Mr. Obama's vanity has clearly drowned his intelligence and good sense as he has apparently come to believe that this country needs him in office more than it needs a sensible, pro-growth economic policy, a forceful and principled foreign policy, and a civil tone in conducting its political affairs. Unfortunately, it increasingly appears like we will be living with another four years of him since the more we see of Mitt Romney, the less genuine substance there appears to be. Then again, if Mr. Romney can't manage to win Michigan, the Republicans might finally wake up and realize they have a dead-man walking candidate and realize they are squandering a rare opportunity to dethrone a sitting president and recruit a viable candidate who can win in November (Jeb are you listening? Chris will you reconsider please? Mitch are you out there?) The market seems to be ignoring the increasing probability of an Obama re-election, but then again it is ignoring a lot of macro headwinds. Then again, maybe four more years of a government without a budget is just what the market ordered.

The markets have been celebrating the January jobs report and other indications that the U.S. economy is picking up steam and the European debt crisis may be easing. In our view, the markets are getting a bit ahead of themselves. The level of the VIX represents complacency in the face of severe systemic risks that have not been resolved. The good news about that observation is that, if it is correct, the VIX offers an inexpensive way to hedge some of those risks. The bad news is that the markets are vulnerable to a correction upon little notice, as we have over the last week.

While the LTRO program has stabilized European bank funding, the long-term prospects for the Eurozone remain bleak. The Mideast is experiencing even greater instability than

usual as Iran continues to dare Israel to attack its nuclear sites¹ and Syria butchers its own people (again – that’s what Syria does) while Obama does nothing (while some say you can’t save everyone, selective intervention sets dangerous precedents and compromises the U.S.’s global authority²). While it is fair to say that there are always systemic risks bubbling under the surface, the particular constellation of risks currently in place could destabilize markets on very short notice. That is one reason that the world’s central banks have been more accommodative than any prior time in history. Whether this accommodation is the correct approach is the subject of intense debate, and as suggested at the beginning of this issue, it is appropriate to frame that debate in terms of concepts like character and integrity. Global leaders are seen as being guided by expediency and politics rather than principle, leaving their ability to manage a crisis in doubt. If we can restore more constructive qualities to the decision-making process, that would be an important step toward achieving principled intellectual and moral solutions to the systemic challenges that face us. It would be nice to think they could begin with Greece, but the odds of that happening are very low.

Greek tragedy, or Greek comedy?

Woody Allen famously defined comedy as “tragedy plus time,” a description that we can only hope will come to fit Greece at some point in the future. For the moment, however, Greece is living up to the tragic tradition of its ancient playwrights as the country is being driven into penury and violence by the failure of not only its own leaders but the rest of European leadership to accept the reality that Greece must leave the European Union as soon as possible. As disruptive and painful as that would be, the alternative will be even worse – a slow but steady death spiral until Greece ends up a failed state economically, politically and socially.

The negotiating process surrounding Greece’s finances is a particularly cloying example of a process bereft of character, intelligence or honesty. The debate over whether Greece is going to default long ago lapsed from tragedy into farce. Greece defaulted a long time ago. The country remains abysmally incapable of paying its bills going forward. Forcing it to take further austerity measures is like asking a starving man to reduce his diet even further and then expecting him to run a marathon. Greece cannot possibly survive inside the European Union. Its economy is incapable of competing within the single currency. The

¹ Iran also dares the rest of the world to isolate it or worse with its apparent sponsorship of terrorist attacks in India and Thailand this week. Now that economic sanctions are starting to bite, the next steps should be tightening the noose on Iran’s central bank, instituting a military embargo on Iranian ports and borders, and further assassinations of Iranian nuclear scientists.

² The bottom line is that Syrian President Assad needs to be removed at the earliest possible time for both humanitarian and strategic reasons. He has not only committed crimes against humanity but is a dangerous enemy of America and Israel. Whoever replaces him could not possibly be worse (and that is quite a condemnation given the situation in the Middle East).



sooner the country readopts the drachma, devalues it against the Euro, and is allowed to choose its own destiny instead of ceding its affairs to Brussels and Berlin, the better the chance it will have of avoiding a truly tragic ending. European leaders are delusionary in refusing to acknowledge the truth and facilitate Greece's departure from the EU as painful as that would be. The alternative is going to make last weekend's Athens riots look like a sunset in Mykonos.

Markets are sentiment machines

In the face of these macro risks, *The Credit Strategist* still remains sanguine about the near-term prospects for certain risk assets such as dividend paying stocks and high yield bonds and bank loans. But investors should not get ahead of themselves. In the spirit of Richard Farina's cult novel *Been Down So Long It Looks Like Up To Me*, we can't get overly excited about an economy that may achieve 3 percent real growth after some statistical gyrations that would do proud the *Qi Qi Har Acrobatic Troupe* at the *Ringling Brothers & Barnum & Bailey Circus*. If growth falters, the Federal Reserve will no doubt jump to the rescue with another bout of quantitative easing, which would support risk assets. While some Fed governors are expressing well-reasoned reservations about the central bank's incessant easing policy, it appears that Chairman Bernanke and a majority of his colleagues are hell-bent on preventing natural economic forces from running their course.³

The prolonged period of zero interest rates is distorting normal economic forces and the pricing of financial assets. PIMCO Chairman Bill Gross said something very profound in the recent *Barron's* Roundtable: in a world of zero interest rates, we are now living in the universe of Einstein and no longer that of Newton. That may explain some anomalous economic behavior that was recently pointed out by David Rosenberg, who remains unimpressed with recent economic data. For example, Mr. Rosenberg pointed out that while automobile sales are up 11 percent from a year ago, miles driven were down by one percent. As he succinctly put it: "[s]o people are buying more cars but using them less." Perhaps people are finally replacing their aging vehicles but keeping them in the garage due to high gasoline prices? Then he points to consumer credit, which soared in December by \$19 billion while total consumer expenditures dropped by \$2 billion – "[s]o people are borrowing more but spending less."⁴ Finally, despite the reported 2 million jobs created over the past year, federal government income tax revenues are down by 1.5 percent. More lower paying jobs and lower overall compensation on Wall Street and elsewhere?

³ We disagree with the argument that the U.S. is in the midst of a self-sustaining economic recovery. The recovery would be much weaker without the Herculean easing efforts of the Federal Reserve. The concept of a self-sustaining economic recovery is inconsistent in our minds with zero interest rate policy.

⁴ David Rosenberg, Gluskin Sheff, *Breakfast with Dave*, February 9, 2012, p. 3.



The narratives constructed to support a bull market do not need to be true to affect stock market prices. The Internet Bubble of the late 1990s is a case in point. That period saw some of the most preposterous rationalizations for stock prices swallowed hook-line-and-sinker not only by the masses but by experienced stock market investors. But the stock market is not a truth-telling machine; it is a sentiment machine. It is also a momentum machine that feeds off the madness and psychology of crowds, especially crowds bearing computers that tie them to social networks. That is why investors should spend as much time studying psychology as economics. As I argued in *The Death of Capital*, one of the reasons thinkers such as Adam Smith, Karl Marx, John Maynard Keynes and Hyman Minsky were able to provide such profound insights into economics was that they saw deep into the human soul and understood the irrational forces that drive human behavior. Men and women invest based on their beliefs about what is true, which often bears a limited relationship to the actual truth. So it is incumbent upon those of us who advise others about their investments to first determine what is actually going on and then try to figure out what the consensus believes is going on.

Today, *The Credit Strategist* believes that the consensus is more optimistic about the economy and where it is going to take the market than the facts suggest is merited. That tells us to be prudent with respect to risk assets and to keep a sharp eye on the macroeconomic headwinds – over-indebtedness, the Eurozone debt crisis, geopolitical instability focused on the Middle East – that could disrupt the markets suddenly and violently.

Investment recommendations

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The Credit Strategist
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