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Investment Outlook

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Lovin' Spoonful

There's a surfeit of instructionals on the secret to investing, ranging from *Investing for Dummies* to *The Intelligent Investor.* My bookshelves at home are full of them, and I've learned or at least absorbed something from many. Experience is a great teacher, but the foundation of civilization, and too investing, is also dependent upon the capsulization of the experiences of others and that is where books have played a formative part in my own career. Still, there's never been a book called "Common Sense for Dummies," which would be required reading in my investment class if either existed. That's an oxymoron to begin with, though, which points to the obvious – that common sense cannot be taught. It's like sex appeal – you either have it or you don't, although both are subject to relative judgments of the observer. What is commonsensical to one investor may seem ludicrous to someone else. And even in cases where history has validated the irrationality of one investment idea or another – the subprime frenzy being perhaps the most recent – there are questions of timing. Michael Lewis's book *The Big Short* is not only a tale of the validation of common sense, but of its delicate shelf life. Most of Lewis's heroes were almost all closed out by their own clients before their logic blossomed and their profits multiplied.

I've written on this topic before – an *Investment Outlook* in November of 2008 spoke to the necessity for a CQ – Common Sense Quotient – in addition to an IQ in order to succeed in investing. Actually, if a chef were to concoct a gourmet investment recipe, he would likely blend a teaspoon of intelligence with a tablespoon of common sense, but the same proportions would probably not apply in other professions. I can visualize the mad scientist irrationally pursuing an obvious dead-end only to – poof – incredibly discover penicillin or a cure for the common cold. Not so with investing, because prices are a delicate combination of mathematical value and human nature – something that quantitative scholars and practitioners rejected to their eventual ruin in their pursuit of "efficient" markets. And human nature, it seems, cannot be so easily modeled nor intelligently divined. It feeds on itself quite frequently, leading to accentuated periods of "greed" and "fear" that tend to be labeled "bubbles" or "black swans," respectively. It is during those periods that a tablespoon of common sense is just the recipe for investment success.

Hanging on the wall above my office credenza is a portrait of Bernard Baruch, who authored the quotation, "Two plus two equals four and no one has ever invented a way of getting something for nothing." Well, we've been there recently, with Dot Coms and subprimes and the financed-based prosperity of the past several decades. He also said, "Two plus two equals four, and you can't keep mankind down for long." Been there too, it seems, and the last 12 months are an apt example. Whatever the future holds, remember that a tablespoon is larger than a teaspoon, and that CQ beats IQ most of the time in the investment world. "Two plus two equals four" needs a lot of CQ, but requires only a second grader's IQ.

In all of the hullabaloo over Goldman Sachs, a CQ analysis of the rating services – Moody's, Standard & Poor's and Fitch – has escaped front-page headlines. Not that a number of observers haven't been on to them for a few years now, including yours truly. Back in July of 2007 some of you will remember my description of their role in the subprime crisis. "Many of these good-looking girls are <u>not</u> high-class assets worth 100 cents on the dollar. You were wooed, Mr. Moody's and Mr. Poor's, by the makeup, those six-inch hooker heels and a 'tramp stamp.'" Now, it seems, I was a little long on humor and a little short on the reality. Tramp stamp and hooker heels do not begin to describe the sordid, nonsensical role that the rating services performed in perpetrating and perpetuating the subprime craze, as well as reflecting the general deterioration of investment common sense during the past several decades. Their warnings were more than tardy when it came to the Enrons and the Worldcoms of ten years past, and most recently their blind faith in sovereign solvency has led to egregious excess in Greece and their southern neighbors. The result has been the foisting of AAA ratings on an unsuspecting (and ignorant) investment public who bought the rating service Kool-Aid that housing prices could never really go down or that countries don't go bankrupt. Their quantitative models appeared to have a Mensa-like IQ of at least 160, but their common sense rating was closer to 60, resembling an idiot savant with a full command of the mathematics, but no idea of how to apply them.

But I come not to bury the rating services, but to dismiss them. To tell the truth, they can't really die – they serve a necessary and even productive purpose when properly managed and more tightly regulated. A certain portion of the investment world will always need them to "justify" the quality of their portfolios. Governments and regulatory bodies say so – it's the law. In 1975 the SEC officially designated the aforementioned three rating agencies as "Nationally Recognized Statistical Ratings Organizations." For all intents and purposes, that meant that regulated financial intermediaries such as banks, insurance companies and importantly pension funds would be guided by the sanctity of their ratings.

Such services, however, while necessary in the ongoing scheme of financial regulation, are overpriced as well as subject to the influence of the issuer, which in turn muddles their minds and clouds their judgment to say the least. E-mails from S&P employees have been cited discussing massaging subprime statistics in order to preserve S&P's market share relative to their two competitors. PIMCO's Paul McCulley said it as only he can – "[The breakdown of our financial system] was about the invisible hand having a party, a non-regulated drinking party, with rating agencies handing out the fake IDs!"

Still, as future bond issuers belly up to the bar with their rating agency seals of approval, it is incumbent on the buying public to treat those IDs with a healthy skepticism. Firms such as PIMCO with large credit staffs of their own can bypass, anticipate and front run all three, benefiting from their timidity and lack of common sense. Take these recent examples for instance: S&P just this past week downgraded Spain "one notch" to AA from AA+, cautioning that they could face another downgrade if they weren't careful. Oooh – so tough! And believe it or not, Moody's and Fitch still have them as AAAs. Here's a country with 20% unemployment, a recent current account deficit of 10%, that has defaulted 13 times in the past two centuries, whose bonds are already trading at Baa levels, and whose fate is increasingly dependent on the kindness of the EU and IMF to bail them out. Some AAA!

Now let's go the other way. GMAC, that only too recently near-bankrupt finance company, carries recently upgraded B ratings from the rating services. Profiles in courage for all three, I say! I mean the U.S. government has injected $20 billion of capital and owns 65% of the company. It's the auto industry's equivalent of FNMA and FHLMC, except those are AAA and GMAC is B with a "positive outlook!" For that, you can buy a GMAC two-year bond at 6½% (8% with what are called "smart notes" that *Investment Outlook* readers can buy through their broker), while you receive only 1.2% at Fannie and Freddie. Vive la différence!

No one or no one company has a monopoly on investment or ratings expertise. Second grade intelligence and a high CQ are a rare combination for an individual rating agency or an investment management firm as well. Still, the rating agencies in recent years have displayed little of either. In addition, they have brazenly sold their reputations for unbiased judgment to the very companies they were standing in judgment upon. Don't bury them however; like vampires in the dead of the night they will outlast us all. Those looking to profit at their expense, however, will <u>dismiss</u> them. They no longer serve a valid purpose for investment companies free of regulatory mandates that can think with a teaspoon of IQ and a tablespoon of CQ.

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