

## Warren Buffett – Practising Patience

Warren Buffett, arguably the world’s greatest investor, boasting a compounded return in excess of 20% over 46 years, attributes much of his own success to patience.

Much noise is created by analysts, stock brokers, economists, journalists, newspapers and financial magazines compelling us to do “this” and do “that”, particularly when the stock market is rising. It must be remembered that all of the above earn their living by encouraging investment activity. On the whole, the more transactions, the more revenue.

It is difficult to stay informed in a fast changing world and not be compelled to be moving in and out of various opportunities for fear of missing out.

Some of Buffett’s wisdom, quoted below, encourages us to be more patient with our investing, having a plan and rigidly sticking to it.

- + “Much success can be attributed to inactivity. Most investors cannot resist the temptation to constantly buy and sell.”
- + “Lethargy, bordering on sloth should remain the cornerstone of an investment style.”
- + “An investor should act as though he had a life time decision card with just twenty punches on it.”

**This is not a time for conviction, rather a time for great patience and care.**

## What to make of all of this and where to from here?

The world is on a journey to an unstable destination, through unfamiliar territory, on an uneven road and critically, having already used its spare tyre. (PIMCO May 2010)

The issues that will provide the most direction for markets in the remainder of the 2010 calendar are:

1. Will the announcement of a \$1 trillion bail out facility for the Euro zone be enough to prevent the fiscal crisis deepening?

PROBABLY NOT

2. Will the apparent recovery of the US economy continue at its current pace once the \$12 - 15 trillion stimulus package starts to abate and inventory restocking ceases?

PROBABLY NOT

3. Will the Chinese growth story continue?

PROBABLY YES

4. Will the Federal Reserve keep US interest rates at effectively nil?

PROBABLY YES

The developed world has never been so broke all at one time, and on the balance of probability, the world’s financial system stands close to breaking point without government intervention.

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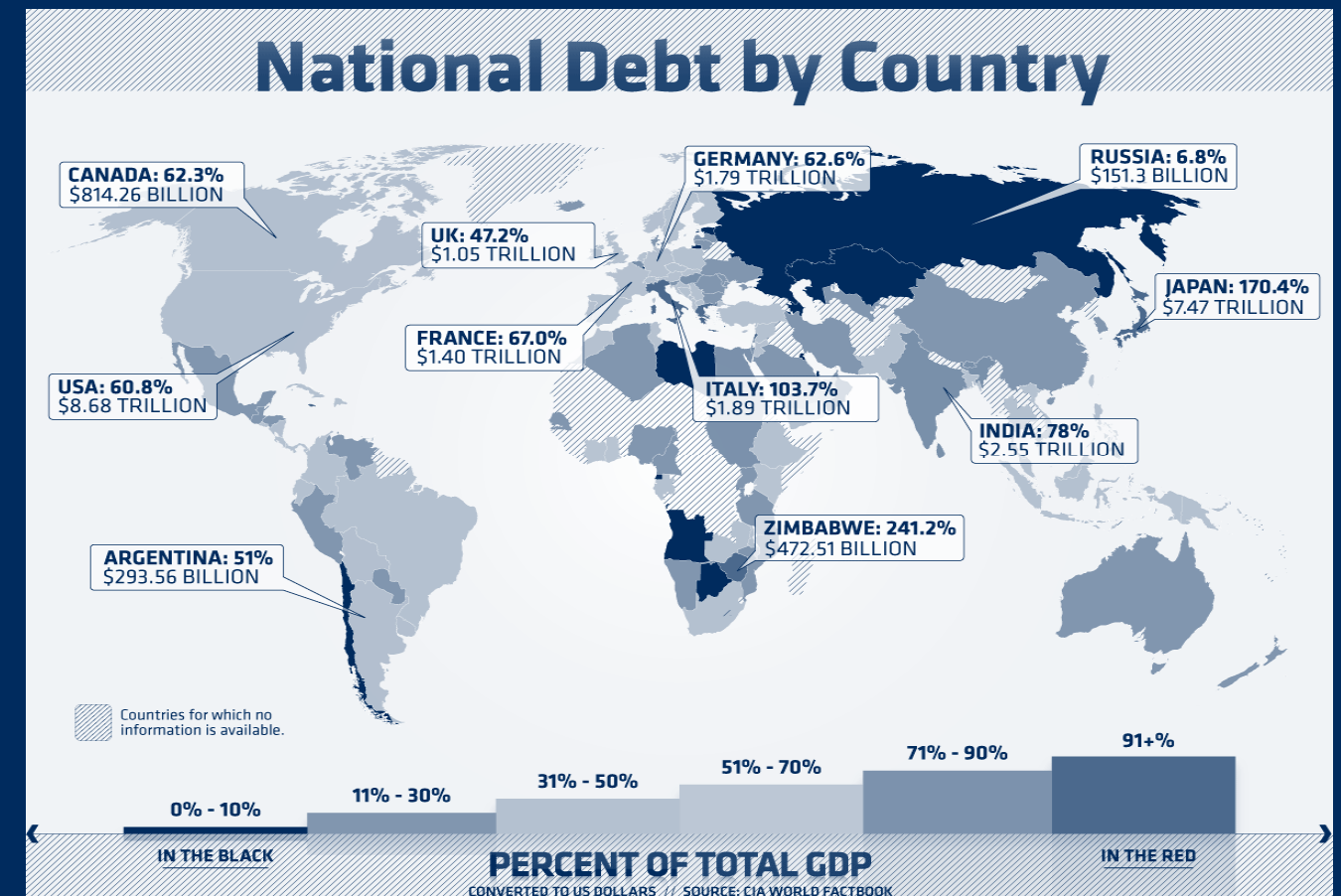
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# Investor News | Views | Clues

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*“If the legacy of the present crisis and emerging sovereign risks are not addressed, we run the very real risk of undermining the recovery and extending the financial crisis into a new phase” (1).*

*“The outlook remains unusually uncertain, and downside risks stemming from fiscal fragilities have come to the fore. A key concern is that room for policy maneuvers in many advanced economies has either been exhausted or become much more limited. Moreover, sovereign risks in advanced economies could undermine financial stability gains and extend the crisis. The rapid increase in public debt and deterioration of fiscal balance sheets could be transmitted back to banking systems” (2).*

### Inside this edition:

- + History Lesson – Banker’s Panic 1907
- + Global Fiscal Crisis (GFC)
- + Warren Buffett – Practising Patience
- + Where to from here?

## History Lesson – The Banker’s Panic of 1907

The banker’s panic of 1907 is cited as being the most relevant comparison with the Global Financial Crisis. This crisis was a complete banking sector collapse that unraveled the economic structures of the time. What are the parallels to the present and what can we learn from them?

Preceding 1907 were 12 years of annual growth in excess of 7% pa - these were very good times fuelled by massive credit expansion (debt!). High levels of trade and high levels of employment led to a high level of confidence, many new industries and technologies thrived. Optimism was very high as well as risk tolerance.



BUCKET SHOPS were illegal brokering firms that popped up on side walks. Bucket shops were typically small store front operations that catered to small investors speculating on price movements. No actual shares were bought or sold. Typically a bucket shop made profits from commissions, used high levels of leverage and generally profited when share prices fell by short selling - SOUNDS LIKE A HEDGE FUND TO ME.

The trigger for the 1907 panic was when financiers attempted to profit through financially engineering the demise of the copper market, through a process of leverage, stock lending and short selling...sound familiar? Many newly established investment trusts got caught as liquidity of copper stocks dried up and the price of copper tanked. One of the largest investment trusts, the “Knickerbocker Trust Company”, went broke and news of a crisis spread. There were runs on banks and investment trusts as investors were not to know if their institution had exposure to bad assets, and the financial sector became paralysed.

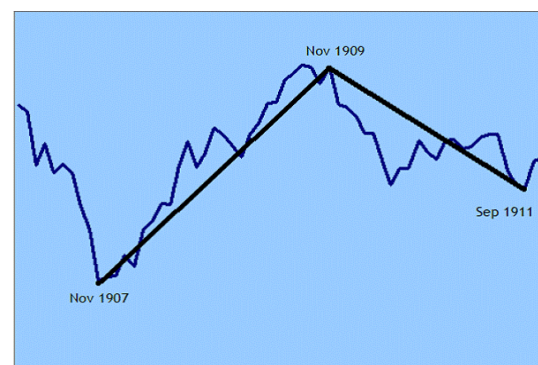
To cut a long story short, JP Morgan, the then 70 year old man and New York’s most famous banker, used his own funds and his own reputation to rally his colleagues to inject cash and instill confidence. WHY? There was no central bank as it was disbanded 70 years earlier in 1836.

The aftermath of the 1907 panic is again eerily reminiscent of recent times. Global trade all but stopped, industrial production plummeted and unemployment nearly tripled as liquidity dried up and the massive deleveraging and re-regulation process began. The relief rally that followed the 1907 crisis tracks nearly exactly the relief rally of 2009/10.

After the relief rally the market then tracked 27% backwards over a two year period until 1911, as the United States economy grappled with high unemployment, high interest rates and the deleveraging process. All at a time when US GDP resumed growth from \$727 billion in 1908 to \$802 billion in 1911. A timely reminder that GDP growth does not necessarily correlate with stock market growth or company earnings for that matter.

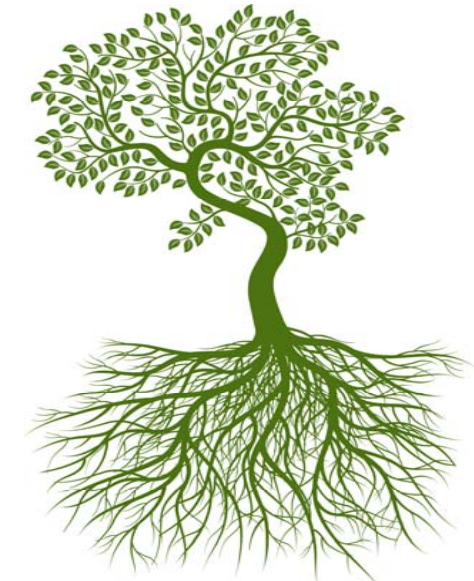
Back to the present. Given that private sector debt has simply been replaced by public sector debt and that the “deleveraging” process has not even commenced yet, it is not unlikely that the stock market will follow the pattern of 1908–1911, as the headwinds created by balance sheet repair become too strong for markets to rally. History is only ever a guide, however so far we are tracking over old ground with remarkable accuracy.

Dow Jones Industrial Average



## Global Fiscal Crisis – Why fiscal solvency matters?

Consider a country as a complex organisation held together by “cash flow” or “money supply” as its financial system. Here we use the analogy of a tree, where the cash flow is represented by the trunk and branches, and the output is measured by the leaves.



The cash comes from the financial sector - the “root system”. The “root system” is a very complex relationship between many players including individuals, corporations, banks, bond holders, central banks and governments. It is held together by economic stability which is fundamentally provided by the government. The “fiscal solvency” of the government is the back stop.

If the “root system” is functioning well, cash is flowing and the tree can grow. The Global Financial Crisis was simply a matter of the financial sector (“root system”) drying up and cash simply stopped flowing. It in fact was a “credit crisis” and it was averted by governments resurrecting availability of (or liquidity of) credit (“credit easing” to use a Bernanke phrase) and guaranteeing the banks to keep the “cash flowing”.

Why do bank economists, analysts, stock brokers, journalists, politicians and financial advisers rarely see a banking crisis coming? Economists focus on what is above the ground, things that can be seen and measured, growth numbers, production numbers, confidence surveys, employment levels, building approvals, etc. All of these rely on a strong “root system” but should not be seen as a sign of a strong “root system”. That is they are trailing indicators of a fully functioning “root system”. The problem for economists and the like is that there is no measurement system for the strength and durability of the financial sector. It is too complex, crosses too many borders and too much is hidden below ground level.

Banking crises have not been uncommon throughout history, there were 13 between 1814 and 1914, and nearly all coincided with historically high levels of debt.

Perhaps the extent of “leverage” in the system is the best gauge we have as to the strength of the financial system. This we can measure. Current “debt to GDP” ratios are dangerously high. Historically, debt levels this high point to further difficulties in the financial sector.

The workings of the “root system” is economically defined by the “Quantity Theory of Money” -  $MV = PT$ . In good times, the velocity of money moving through the system is very high. Since the collapse of Lehman Brothers, governments around the world have brought up “bad assets” to keep the “P” high and through “credit easing” kept “M” high. Stimulus packages kept “T” high which meant that the system kept moving.

The “root system” is currently shallow, governments are fiscally exhausted, and banks are under increasing pressure from regulators to strengthen their capital positions. This means they will lend less and at higher rates and the bond market appears ready to strike at the next most vulnerable victim. The whole “root system” is about to shrink and unfortunately the tree will too. It appears that a meaningful and sustainable global economic recovery is going to take some time as the financial system is still too weak to sustain growth.