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**Leithner & Company's First Decade
and Strategy for the Next Decade**

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Leithner & Company's First Decade and Strategy for the Next Decade

Leithner & Company Pty Ltd (LCO) adheres strictly to the traditional “value” approach to investment pioneered by Benjamin Graham and adapted by his colleagues Warren Buffett, Thomas Knapp and Walter Schloss. Its motto is its method: to undertake investment operations that are based upon thorough research; to provide reasonable safety of principal and offer an adequate return; and to inform its shareholders regularly, fully and in plain language about these investment operations. It strives to remain a low-cost, low-risk and reasonable-and-steady-return investment vehicle.

LCO was formed in May 1999, commenced operations in August of that year and recorded its first investment results for a six-month period (the relevant interval for the declaration of earnings and payment of dividends) in the January-June half of the 1999-2000 financial year. Depending upon one's definition, our tenth birthday either occurred recently or will occur shortly. For that reason, and also given the unprecedented tumult in financial markets that has occurred during the past year (the All Ordinary's loss in calendar 2008 was the worst in its history), this is an appropriate juncture to review our objectives, assess our results and justify the assumptions that will plot our course for the future.

From its inception, LCO has had two objectives:

1. *to preserve wealth* – that is, to safeguard the value of its shareholders' capital by compounding it at a rate which compensates for the insidious effects of the relentless rise of the Consumer Price Index.¹
2. *to build wealth* – that is, to invest its shareholders' capital in a portfolio of securities whose rate of return, given cautious assumptions, can reasonably be expected to exceed the return offered by 5-year Commonwealth Government bonds.² When securities capable of generating such returns are difficult to locate – as was true for virtually all of the past decade – prudence demands that LCO accumulate cash and its rough equivalents – and that it continue to do so until securities become available at attractive prices.

It's essential to bear in mind that LCO is a private investment company and not a managed fund (unit trust). Its corporate structure has important implications for its day-to-day operations and the measurement of its results. As a company, LCO's income derives from the receipt of dividends and payments of interest, and also from the realisation of capital gains (that is, from the profitable sale of assets) – but not from the fluctuations of the market prices of the businesses and securities that comprise its portfolio. A managed fund's results, on the other hand, stem from dividends, interest and capital gains and losses –

¹ It is vital to repeat (a decade of Annual Reports, newsletters, etc., has relentlessly banged this drum): an increase in the prices of consumer goods and services as measured by the CPI is not a *definition* or *synonym* of inflation: it is *one of several possible consequences* of inflation. Others include bubbles in stock, bond and real estate markets, rising interest rates and (in extreme cases) collapses of the currency. Inflation, as British classical school and Austrian School economists define it, is (stripped to its essentials) an increase in the supply of money not backed by a corresponding demand for money (i.e., savings). In an age of fiat money (that is, money whose definition is decreed by government rather than agreed in a free market, and whose regulation the state monopolises), only one entity can create inflation. No person or business or other private organisation (such as a trade union) can inflate the supply of money: only the central bank (using commercial banks as its agent) can.

² For an extended discussion and analysis justifying the yield of the five-year Commonwealth Government bond as a foundation stone of equity analysis – despite the fact that these bonds are more often “loss guaranteed” than “risk free” – see Chris Leithner, *The Intelligent Australian Investor* (John Wiley & Sons, 2005, Chaps. 5, 6 and 11).

whether realised or unrealised. LCO's results thus have everything to do with the income received from the businesses of which it is a part-owner – and (unlike a managed fund) nothing to do with either the price volatility of these shares, bonds, etc., or their price level at a given point in time. For this reason, given identical portfolios an investment company's results will over time tend to be relatively steady and a managed fund's results will be more volatile.

General Portfolio Policy

Stocks and Bonds

“Because of the uncertainties of the future,” Ben Graham said in *The Intelligent Investor* (1949), “the investor cannot afford to put all of his funds into one basket – neither in the bond basket, despite the unprecedentedly high returns that bonds have recently offered, nor in the stock basket, despite the prospect of continuing inflation.” Hence the defensive investor's portfolio management policy: “he should divide his funds between high-grade bonds and high-grade common stocks.” Specifically,

We have suggested as a fundamental grading rule that the investor should never have less than 25% or more than 75% of his funds in common stocks, with a consequent inverse range of between 75% and 25% in bonds. There is an implication here that the standard division should be an equal one, or 50-50, between the two major investment mediums. According to tradition the sound reason for increasing the percentage in common stocks would be the appearance of the “bargain price” levels created in a protracted bear market. Conversely, sound procedure would call for reducing the common-stock component below 50% when in the judgement of the investor the market level had become dangerously high.

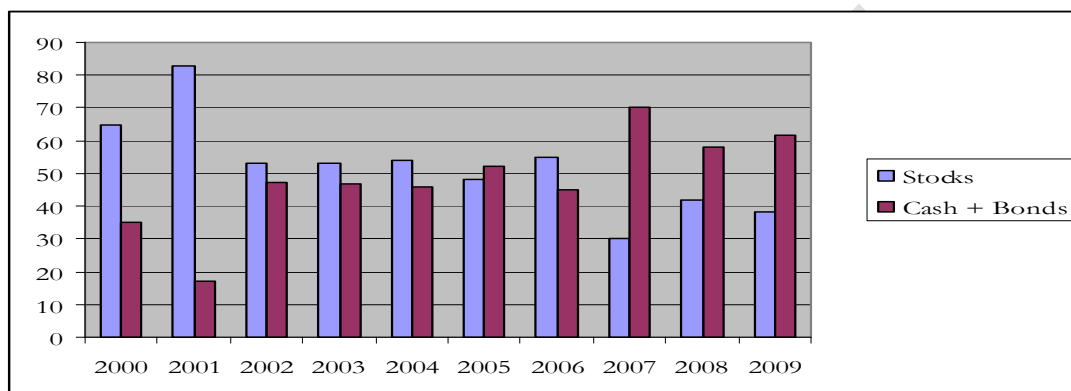
This rule conforms to the laws of economics: in principle, the rational investor strives to buy low and to sell high. But as Graham conceded, this maxim flatly contradicts human psychology. In practice, most people pray for a bull market, rejoice when it appears and seek to buy ever more stocks as their prices rise. Conversely, most people fear and loathe a bear market, and reduce their holdings as prices fall. The result is that, because the heart rules the head, the crowd will buy at high prices and sell at low prices. Grahamite investors, on the other hand, welcome and buy during bear markets, and understand that the bull has only one use: he provides the means to offload holdings at unreasonably high prices.

The “aggressive” investor, Graham continued, “should start from the same base as the defensive investor” – namely a roughly balanced division of his portfolio into stocks and bonds.³ “He will be prepared to branch out into other kinds of security commitments, but in each case he will want a well-reasoned justification for the departure.” Accordingly, except on those rare occasions when he can buy them at a significant discount, he will leave high-grade bonds to defensive investors and instead will focus upon “second grade” bonds (where significant divergences of values and prices are more likely to arise). Similarly (and again except on those rare occasions when his estimate of their value significantly exceeds their price), he will leave “blue chip” stocks to defensive investors, and will concentrate upon smaller, unfashionable and misunderstood companies and special situations.

³ “The defensive investor,” said Graham, “is one interested chiefly in safety plus freedom from bother.” He seeks to maximise the soundness of his sleep and minimise the time and energy he devotes to his investments. The defining characteristic of the “aggressive” (Graham also uses the more appropriate term “enterprising”) investor, on the other hand, is NOT the amount of risk of capital loss he is willing to bear: it is the amount of time and effort he is prepared to devote to the search for and analysis of securities. Like his defensive counterpart, the enterprising investor seeks to sleep well; but unlike the defensive investor, the enterprising investor knows that a full day of diligent, useful and satisfying work begets sound sleep.

Figure 1 categorises LCO’s holdings as either cash deposits or bonds on the one hand or stocks on the other, and expresses each category as a percentage of the entire portfolio on the last day of the last ten financial years. It shows that Leithner & Co. has adhered remarkably faithfully to Graham’s portfolio management policy. Only on one occasion – in 2001 – has the portfolio’s weighting towards shares exceeded the 75% upper bond; and in no year (although we came close in 2007) has stocks’ weighting fallen below 25%. On average, stocks have comprised 52.1% and cash/bonds 47.9% of our portfolio.

**Figure 1:
Stocks and Cash/Bonds
as a Percentage of LCO’s Assets (30 June)**



In a second sense, the composition of our portfolio has conformed closely to Grahamite principles. Reflecting our conviction over the past decade that the prices of stocks in Australia and around the world were becoming ever more unreasonably high, stocks’ weighting has fallen over the years. During 1999-2000 and 2000-2001, stocks comprised two-thirds or more of the portfolio; during the next five financial years, their weighting fell to ca. 55%; and since 2006-2007, it has fallen to ca. 30-40%. LCO cannot *time* the stock market, but it can (albeit roughlyly) *value* it; and having ascertained during the Great Bubble that prices exceeded values by ever greater margins, making bargains ever less numerous and more difficult to locate, we allowed stocks to comprise a steadily falling percentage of our assets. At the time, that was (by mainstream standards) unusual; in retrospect, it has clearly been sensible and suitably cautious.

**Figure 2:
Disaggregating Cash and Bonds
as a Percentage of LCO’s Assets (30 June)**

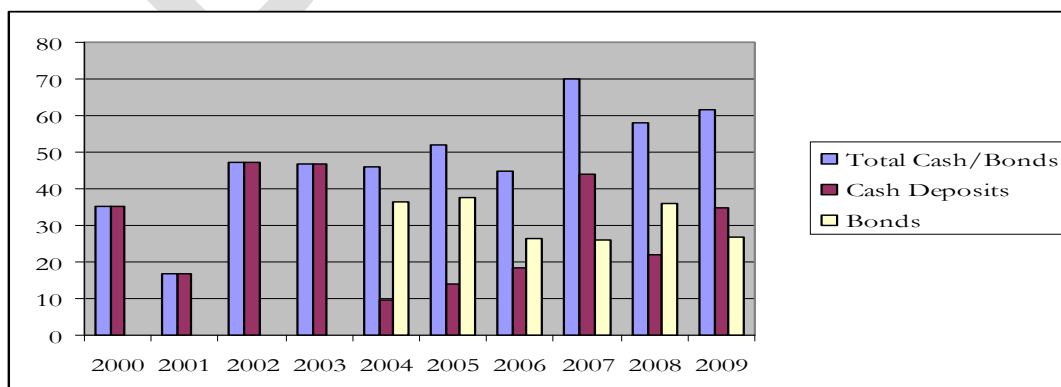


Figure 2 disaggregates the “cash/bond” category in Figure 1 into its two component parts. During the first four financial years, LCO’s portfolio contained no bonds; in 2003-2004, much cash was used to purchase bonds (leaving the total non-stock allocation roughly constant); and since 2004, reflecting the fact that bonds, too, have become unreasonably dear and bargains few in number and difficult to locate, the percentage of assets allocated to bonds has remained roughly steady and cash (in the form of demand and other very short-term deposits) has accumulated. As a result, at the onset of the “Global Financial Crisis” (“GFC”) in mid-2007, LCO owned relatively few (in terms of their percentage of total assets) stocks and a huge (by conventional standards) cache of cash. That very large cushion has stood us in very good stead.

Why So Few Shares?

That’s apparent now, but it certainly wasn’t apparent to the crowd during the boom. “Why isn’t Chris acting like us?” several funds managers asked incredulously at conferences and presentations. “Why isn’t he rejoicing and buying shares like there’s no tomorrow? Chris’ reply seemed to impress nobody. The boom inevitably causes the bust, and the more drunken the revelry the more painful will be the hang-over. During a recession and bear market, hardly anybody avoids the pain. Everybody knows that in 1969 Warren Buffett liquidated his investment partnership and thus evaded the storm that erupted soon thereafter. Few, however, remember that Charles Munger, who later became Berkshire Hathaway’s Vice Chairman, remained fully invested in shares. As a result, \$1.00 of the Munger partnership’s assets on 1 January 1970 shrunk to \$0.54 by 31 December 1974. Add the effect of the CPI, which galloped during these years, and that dollar of assets in Munger’s portfolio 1970 fell to \$0.39 by the end of 1974. Munger subsequently recouped these losses; the point is that when the economic and financial tide turns, only those who are very well prepared can hope to escape its rips.

But why not join the fun while it lasts? Why not speculate rather than invest, ride the train as long as possible and then jump just before it derails? Warren Buffett tells us: “for some reason, people take their cues from price action rather than from values. What doesn’t work is when you start doing things ... because they worked last week for some-one else ... The dumbest reason in the world to buy a stock is because it’s going up.” He practiced what he preaches. During the three years before the Crash of 1987, the Dow Jones Industrial Average doubled. But Buffett bought not one stock – and sold all but his “core” holdings.

Why So Much Cash and So Many Income Securities?

During the boom, the crowd’s derision took a second form. “Your shareholders surely aren’t paying you to hold so much cash!” That attitude belied a fundamental ignorance of investment. LCO’s shareholders have entrusted its Directors, the stewards of the company’s capital, to decide when to hold cash and when to invest it – to determine, in other words, when the expected return from a prospective investment justifies the risks it entails, and when it doesn’t. To invest successfully is to choose among a series of tradeoffs. To hold cash (and carefully-chosen bonds and income securities) is a reasonably safe way of keeping one’s powder dry until compelling opportunities arise. This stance offers a limited return in exchange for reasonable safety of principal. Absent better alternatives, this is the only sensible thing to do. Mr Buffett agrees: “occasionally, successful investing requires inactivity ... [But] when much of the rest of the investing world, burdened by debt, encounters some crisis forcing a panic, we are standing there with no debt and a loaded gun of cash ready to bag rare and fast-moving elephants.”

The underlying problem is that most people have a high time preference: they focus upon the here-and-now, and discount or ignore more distant horizons. As a result, they jump at choices today, and forget that these choices are usually far more limited (and less attractive) than the ones that will present them-

selves in the years to come. By selecting among superficially attractive options available at the moment, they constrain their ability to choose among much better alternatives down the road. Limiting your investments to the ones immediately at hand is like selecting your spouse from among the students in your high school. Most people recognise that more and (and more suitable) options will probably appear further along the track of life. The opportunities of tomorrow compete for today's resources. It's impossible to predict the volume and attractiveness of tomorrow's bargains, but it would be foolish to think they will not exist. Waiting for them is a better strategy than overpaying today. Standing apart from a bullish and fully-invested crowd is gruelling and humbling. Eventually, it's also intellectually satisfying and financially rewarding. That's certainly been our experience.

Results

Figure 3 shows that LCO's *Annualised Return* ("Company") has averaged 17.7% per year, and its *Annualised Return to Class E Shareholders* ("Class E") has averaged 13.2%. Its annualised return includes all investment income (i.e., dividends, payments of interest and other distributions including franking credits), but excludes the unrealised capital gains generated during that interval. *Annualised Return* ("Class E") is the dividend including franking credits paid per Class E share.

**Figure 3: Cumulative Results
Six-Month Periods Since Inception**

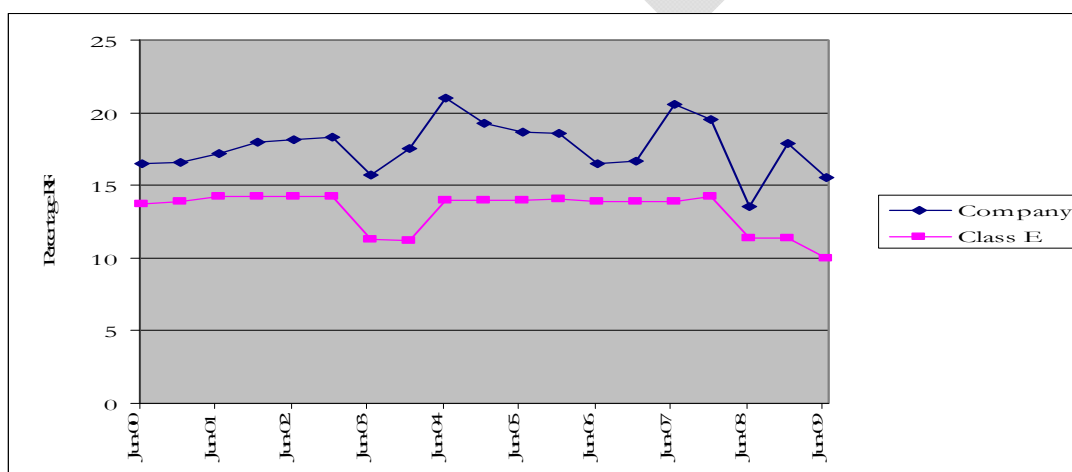
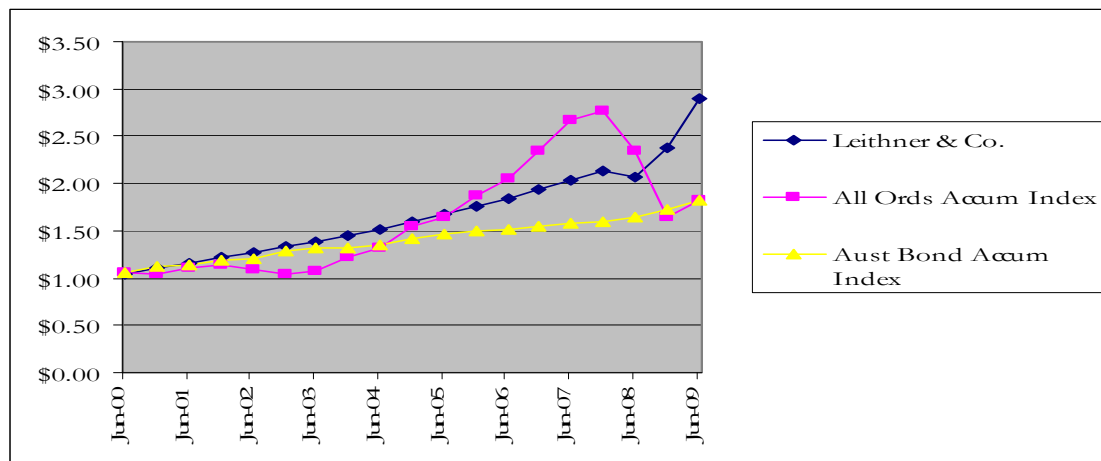


Figure 4 compares our results to the All Ordinaries Accumulation Index and the Australian Bond Accumulation Index.⁴ It shows that each dollar invested in Leithner & Co. on 30 June 1999, if the dividends subsequently received had been reinvested in Class E shares, would by 30 June 2009 have grown to \$2.36 and generated \$0.36 of franking credits and \$0.075 of net unrealised capital gains. Each \$1.00 in 1999 would thus have grown to $(\$2.36 \div \$1.075) + \$0.36 = \2.90 in 2009. This equates to a total gain of 190% and a compound rate of growth of 12.6% per annum. (Obviously, LCO's results cannot be guaranteed and you should not assume that results like those of the past ten years will recur in the next ten years.) Each \$1.00 invested in the All Ordinaries Index in 1999 (dividends reinvested) would have grown to \$1.83 in 2009. This equates to a total gain of 83% and a compound rate of growth of 6.9% per an-

⁴ Based upon the All Ordinaries Index (AOI), which measures changes of the prices of the 500 largest companies listed on the Australian Securities Exchange, the All Ordinaries Accumulation Index (AOIA) measures the combined impact of changes in the prices of stocks and the receipt of dividends and other distributions. The Australian Bond Accumulation Index measures the returns of bond investments in an analogous way.

num. Each \$1.00 invested in the Australian Bond Index in 1999 (payments of interest reinvested) would have accumulated an almost identical sum (\$1.82) by 2009. This equates to a total gain of 82% and a compound rate of growth of 6.9% per annum.⁵

**Figure 4:
Accumulation of Shareholders' Capital Since Inception
(versus Australian Shares and Bonds)**



From June 2002 until December 2004, during which the “Internet Bubble” burst and a mild (in Australia) bear market occurred, LCO modestly “outperformed” the AOAI. As the Great Bubble gathered steam, LCO “underperformed” by an ever-wider margin. Its underperformance decreased considerably in June 2008, and by December 2008 it had once again outperformed the AOAI. The extent of this outperformance increased during the January-June half of 2008-2009. Like the tortoise and the hare, so too LCO and the crowd: we have lagged during bull markets and economic booms, and surpassed during bear markets and busts.⁶

Charles Ellis wrote in *Winning the Loser's Game: Timeless Strategies for Successful Investing* (McGraw-Hill, 2002):

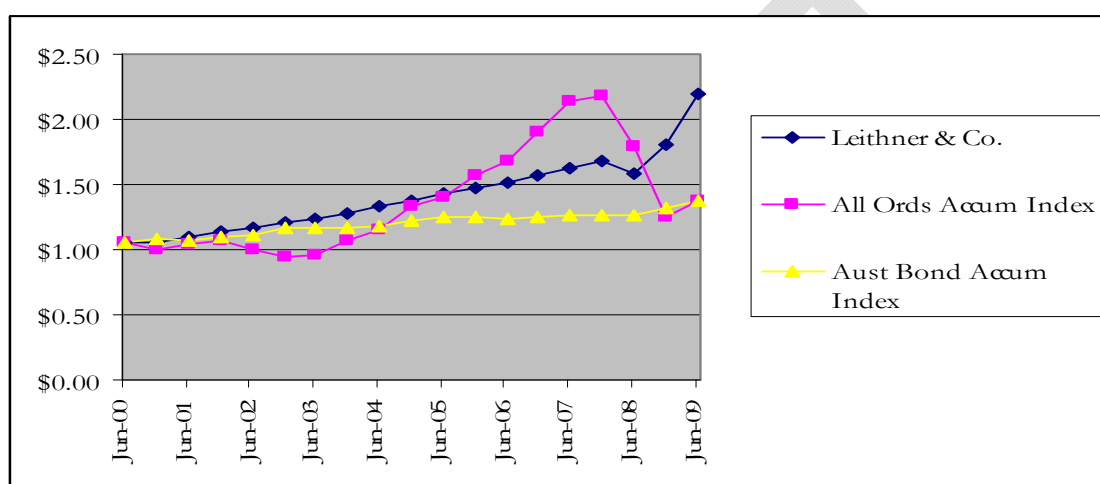
All investors share one formidable and all too easily underestimated adversary: inflation ... For individual investors, inflation has usually been the major problem – not the attention-getting daily or cyclical changes in securities prices that most investors fret about. The corrosive power of inflation is truly daunting: At 5 percent inflation, the purchasing power of your money is cut in half in less than 15 years – and cut in half again in the next 15 years. At 7 percent, your purchasing power drops to 25 percent of its present level in just 21 years – the elapsed time between “early” retirement at 61 and age 82, an increasingly normal life expectancy. This is clearly serious business, particularly when the individual is retired and has no way to add capital to offset the dreadful erosion of purchasing power caused by inflation.

⁵ That’s right, Virginia: over the past decade, Australian stocks have not “outperformed” bonds. This is fundamental, yet few have come to terms with it (or even recognised it). Relatively more risky assets (shares) have not “outperformed” less risky assets (bonds). In this sense, the Australian “equities bubble” has not – yet? – burst.

⁶ And like the “Superinvestors of Graham-and-Doddsville” (a small collection of investors whose long-term track records Warren Buffett analysed in an article of that name, which since 1973 has been appended to *The Intelligent Investor*) other than Buffett, LCO has “underperformed” roughly one-third of the time. Alas, the results generated for Class E shareholders over a decade are only ca. two-thirds of the average achieved by Buffett’s “Superinvestors” over much longer intervals.

Figure 5 discounts the results in Figure 4 by the CPI – that is, it restates the data in Figure 2 in constant (June 1999) purchasing power. It shows that each dollar invested in LCO on 30 June 1999, if each of the dividends received had been reinvested in the Company’s Class E shares, would by 30 June 2009 have grown to \$2.19 of purchasing power. One’s original investment, in other words, augmented by periodic dividends, increased in “real” value by 119%, i.e., at a compound rate of 9.1% per annum. Each \$1.00 invested in the AOIA in 1999 would have grown to \$1.38 of purchasing power in 2009. This equates to a total gain of 38% and a compound rate of growth of purchasing power of 3.6% per annum. Each \$1.00 invested in the Australian Bond Index in 1999 (payments of interest reinvested) would have accumulated an identical amount of purchasing power (\$1.38) by 2009.

**Figure 5:
Accumulation of LCO’s Capital Since Inception
(versus Australian Shares and Bonds, net of CPI)**



On the basis of the data in Figures 1-5, we conclude that, during its first ten years of operation, Leithner and Company has conformed to Grahamite principles. As a result, it has

- preserved its shareholders’ wealth: it has compounded its capital at a rate which has exceeded – and thus compensated for the effects of – the inexorable rise of the Consumer Price Index. It has also
- built its shareholders’ wealth: it has invested its capital in a portfolio of securities whose compounded rates of return (whether in “nominal” or “real” terms) has exceeded that offered by 5-year Commonwealth Government bonds.

Some Details of LCO’s Results

Payments of Interest, Dividends and Realised Capital Gains

It’s important to emphasise: as a company, LCO’s income derives from the receipt of dividends (from stocks) and payments of interest (from cash balances and bonds), and also from the realisation of capital gains (that is, from the profitable sale of stocks and bonds) – but not from the fluctuations of the market prices of the businesses and securities that comprise its portfolio. Figure 6 shows the percentage of LCO’s income derived from each of these three sources of income (expressed as a percentage of all income received during a financial year) for each of the past ten financial years.

Reflecting the decreasing percentage of LCO's assets invested in shares (and also its increasing concentration upon "special situations" predicated upon eventual capital gains rather than regular dividends), the percentage of income derived from dividends has fallen steadily and cumulatively drastically (from 90% in 1999-2000 to 8% in 2008-2009). Over the decade, dividends comprised an average of 37% of the income earned during each financial year. Reflecting the increase over time of cash and bonds as a percentage of LCO's investment portfolio (as well as the sharp rise of interest rates from 2004 until mid-2008), the percentage of income derived from payments of interest has risen erratically and quite significantly, from 10% or less in the first three financial years to 51% in 2007-2008. For the entire ten-year period, payments of interest comprised an average of 21% of LCO's income during each financial year. Finally, the percentage of LCO's income derived from the profitable sale of assets (net of the unprofitable sale of assets) has, since 2001-2002, remained remarkably constant. For the entire ten-year period, capital gains comprised an average of 42% of the income during each financial year.

Figure 6:
Categories of Income Received Since Inception
(as a Percentage of All Income Received)

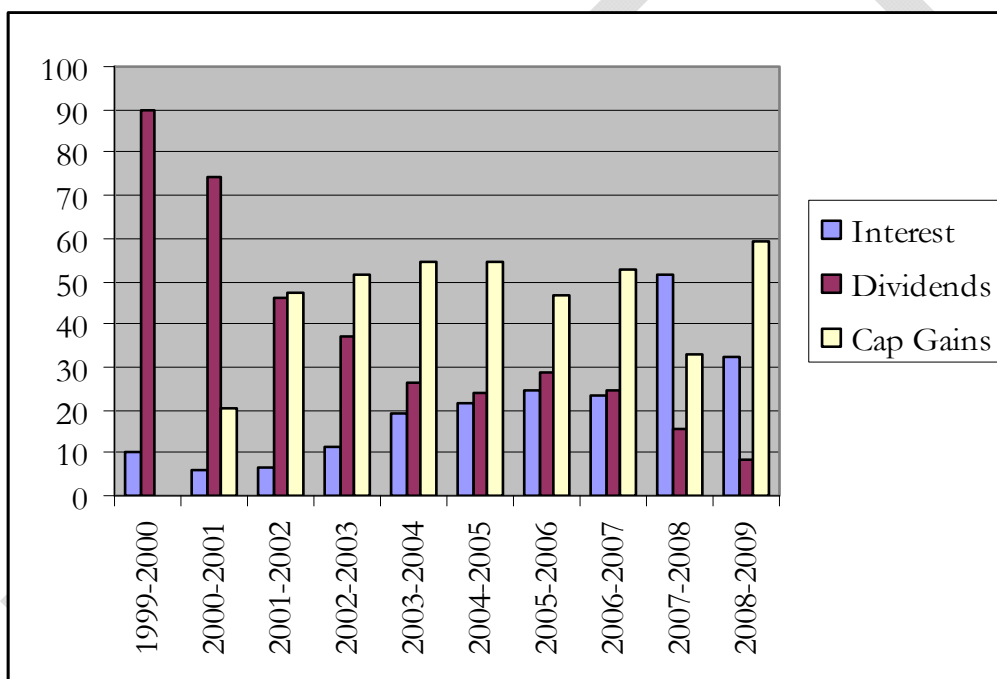
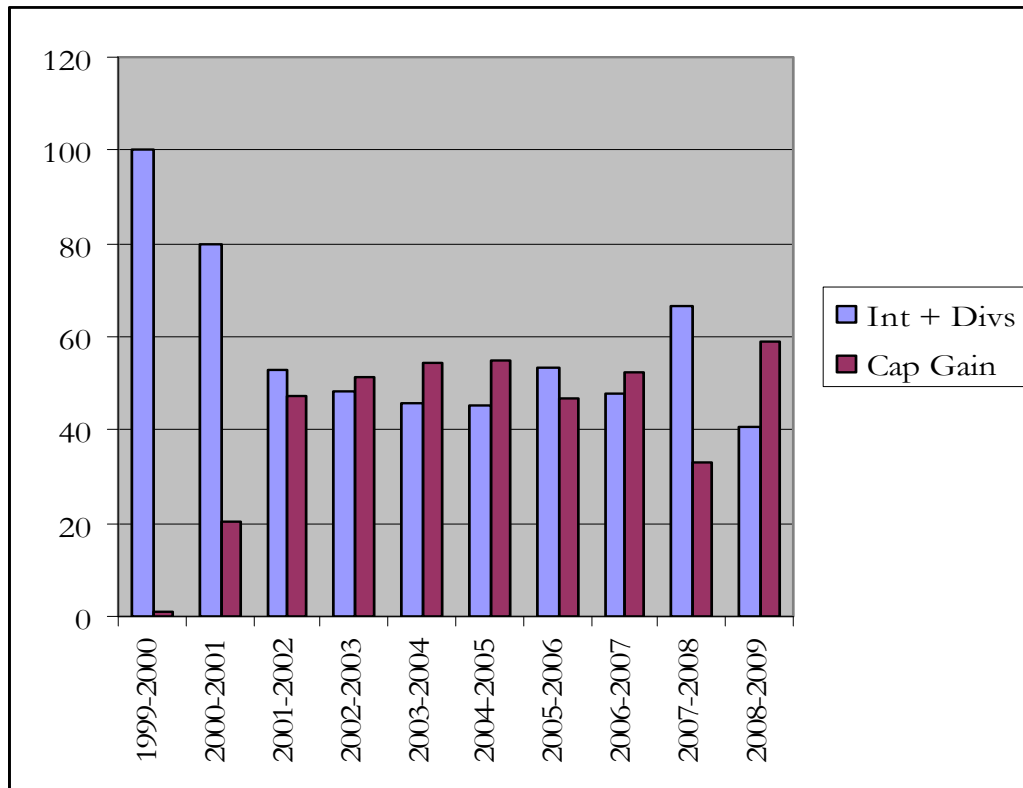


Figure 7 restates the data in Figure 6 by reducing the categories of income from three to two. It combines the income received from dividends and payments of interest into one category (which comprises a reasonably regular stream of income), and retains the income received from capital gains (net of capital losses) as a second category (which comprises irregular lumps of income). Beginning in 2001-2002, each category has generated approximately half of LCO's income. Over the decade, interest and dividends have provided an average of 58% and net capital gains an average of 42% of annual income. Although many people discount their importance, dividends and payments of interest are clearly a *sine qua non* of reasonable long-term investment results. Further, LCO's earnings and dividends per share (refer back to Figure 3) have been comparatively stable because it has relied (by a roughly two-to-one margin) upon a regular rather than an irregular source of income.

**Figure 7:
Streams vs. Lumps of Income
(as a Percentage of All Income Received)**



Number of Securities Held, Length of Time Held Before Sale

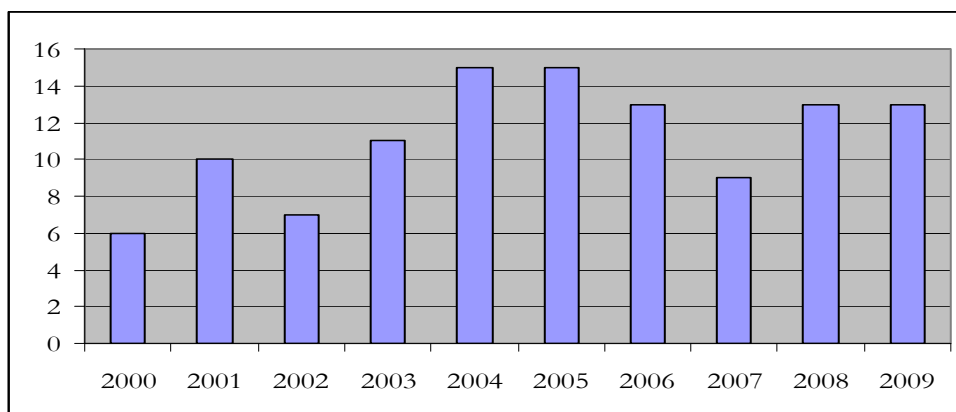
In one respect, LCO’s portfolio has resembled a “Buffett” rather than a “Graham” portfolio: it has consistently comprised a small number of securities. Between 1926 and 1956, Graham usually held scores (and not infrequently over 100) stocks and bonds. Buffett’s portfolios since the 1950s, on the other hand, have tended to hold ca. 20-30 stocks (he has usually eschewed bonds). Yet even by Buffett’s standards, LCO’s portfolio has been concentrated: since 1999-2000, it has averaged only 11.2 securities (see Figure 8).

This concentration reflects LCO’s conception of risk and its mitigation. We have sought to diminish the risk of capital loss not by *diversifying* the portfolio among a large number of stocks and bonds which we have only superficially analysed; rather, we have sought to reduce this risk by *concentrating* the portfolio among those securities which exhibit the greatest shortfall between purchase price and perceived underlying value – that is, those securities which our analysis tells us are most likely to provide the greatest “margin of safety” against financial loss over the long term.

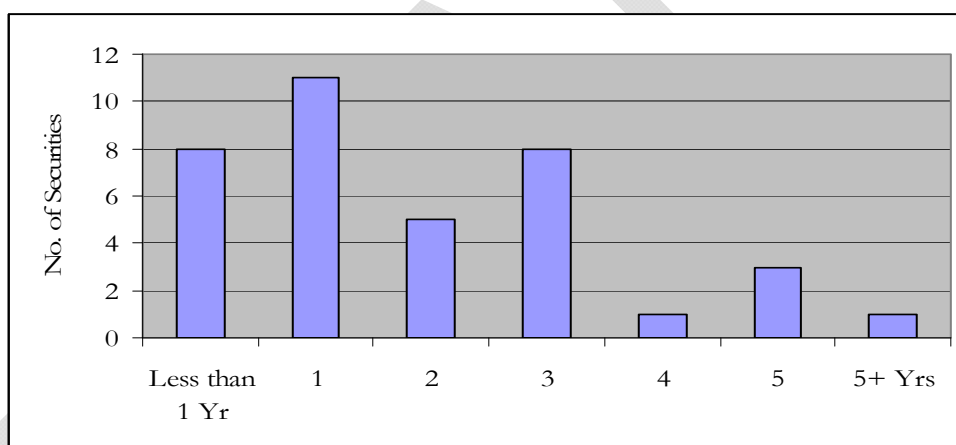
Of all people, John Maynard Keynes (always an execrable economist but eventually a good investor) understood this point. “As time goes on I get more and more convinced,” he wrote to the board of National Mutual (which he chaired) in 1934, “that the right method in investment is to put fairly large sums into enterprises which one thinks one knows something about ... It is a mistake to think one limits one’s risks by spreading too much [among] enterprises about which one knows little and has no reason for special confidence.” In a memo to the Provincial Insurance Company (which he advised) in 1938, he

added: “to carry one’s eggs in a great number of baskets, without having time or opportunity to discover how many have holes in the bottom, is the surest way of increasing risk and loss.”

**Figure 8:
Number of Securities in LCO’s Portfolio (30 June)**



**Figure 9:
Length of Time Securities Held in LCO’s Portfolio Before Sale**



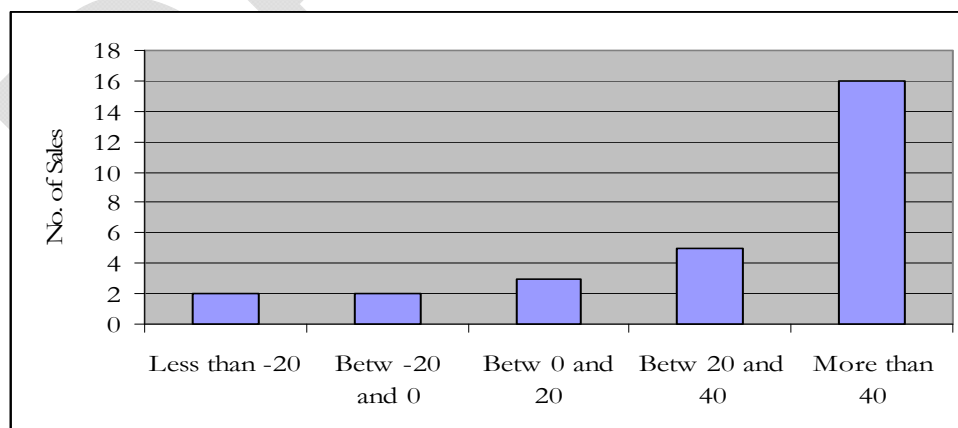
No security enters our portfolio without extensive research, and our analyses assume that (if we buy it) we will retain a given security at least five years. We cannot assume that the gap between price and value will close quickly, and must allow the realisation of full value to take its time. Further, as we have seen, dividends and payments of interest have generated roughly half of our investment income; in order to benefit fully from the compounding effect of streams of distributions, we must retain securities for several years or more (for details, see *The Intelligent Australian Investor*, chap. 11). Yet as Figure 9 shows, our average holding period has been much shorter: just 2.2 years. Only on one occasion has a security been held more than five years, and only three securities were held five years. In this sense, too, LCO’s portfolio is typically Grahamite. For many of his purchases, Graham assumed a holding period of a couple of years. Although he urged that defensive investors consider a “dollar cost averaging” approach (whereby equal dollar amounts are invested every month or quarter, etc.), Graham was not, as a rule, a “buy and hold” investor. In sharp contrast, on numerous occasions Warren Buffett has stated that, once he buys a stock, his preferred holding period is “forever.”

Why the disparity between the assumption underlying our analyses of securities and the much shorter actual holding period? A case-by-case examination uncovers two explanations. First, it appears that some corporate raiders think like we do. Within a year or two of our purchase of a small percentage of a company's shares, a corporate raider spotted the same divergence between price and value – and decided to purchase all of its shares. Of the 28 sales depicted in Figure 9, 18 (64%) were forced either by the compulsory acquisition provisions of the Corporations Act (whereby a raider who buys 90% of a company's stock can compel the owners of the remaining 10% to sell to him) or the redemption of a bond (which is usually triggered by a change-of-control event such as a takeover). Second, the phrase “the higher they rise, the harder they fall” seems to have a corollary: “the harder they fall, the more quickly they rise.” “Many shall be restored that are now fallen, and many Shall fall that are now in honour.” This line, from the Roman poet Horace's *Ars Poetica*, appeared opposite the title page of Graham's seminal text *Security Analysis*. Regression to the mean underlies many of the developments in financial markets, and constitutes a cornerstone of LCO's approach to investment. In our experience, the more extreme has been the disparity between the price of a company's shares and their value, the more quickly at least part of that disparity has narrowed.

Selling Assets: The Distribution of Winners and Losers

Given our very concentrated (by mainstream standards) portfolio, we have not bought many securities; consequently, we have not sold many either. But as Figure 10 shows, over the last ten years we have tended to sell them profitably. The distribution is skewed heavily to the right – that is to say, more than half have been sold at a gross profit of 40% or more. A case-by-case examination shows that this skew results from three things (not necessarily in this order): our rigorous standards of analysis and selection, a bull market that lifted all boats, and sheer good luck. Balancing our good luck has been some bad luck: 4 of the 28 sales (14% of the total) have generated capital losses, two of them appreciable. During the next couple of years, we expect that the tails of the distribution in Figure 10 will fatten: 2-3 stinkers will be sold, but their losses will be dwarfed by the gains from 3-4 gushers.

**Figure 10:
The Distribution of Capital Gains and Losses (Gross Percent)**



That Was Then, But This Is Now: What About the Next Decade?

The price of independence and prosperity includes scepticism and vigilance – of one's rulers and their policies, of economic and financial orthodoxies, and of the stewards of one's capital. Further, civility costs nothing and buys everything. Let us therefore place ourselves in the position of a sceptical (of us and our results) and civil shareholder. “You've not been a bad steward,” she might say, “but perhaps

you've simply been a lucky one." Moreover, "for the past year the Prime Minister and Treasurer have never missed an opportunity to remind us that the present 'Global Financial Crisis' is the worst since the 1930s, and they insist that if it weren't for their policies – particularly their mammoth 'stimulus' which, relative to the size of the economy, is bigger than America's and Britain's – Oz would find itself in a very bitter pickle." "Surely," she might conclude, "your deeply jaundiced view of governments is badly out of step with the times. After all, events of the past year or two demonstrate that politics is our salvation and politicians are our saviours. If so, then in the future Leithner & Co.'s results may well suffer."

What We Have Long Believed and Continue to Believe: A Recapitulation

We've certainly been (and remain) marching to the beat of a non-mainstream drummer. It's precisely for that reason, we maintain, that we've been able to generate reasonable results. "There are two requirements for success in Wall Street," Ben Graham told an interviewer a year before his death. "One, you have to think correctly; and secondly, you have to think independently." It's possible that we've been and remain well ahead of the times. Virtually from LCO's inception, and unlike virtually everybody else, we expected a severe recession and bear market. Although we couldn't predict *when* the reckoning would occur, we deduced roughly *what* would transpire. Because we had been expecting a "Global Financial Crisis" (GFC), its arrival did not surprise us.

Although their details and emphases have differed, the themes of practically every Annual and Half-Year Report since 2000 (and of most Leithner Letters since 2002) have been drearily monotonous. First, individuals, businesses and especially governments have long lived well beyond their means. Although the mainstream stridently denies it, saving and production – not borrowing and consumption – beget prosperity. You simply cannot borrow and consume your way (and the government cannot print its way) to plenty. Instead, savings, entrepreneurship and the accumulation of capital cause standards of living to improve. Greater amounts of more efficient capital render labour more productive; this, in turn, begets greater output per worker, which enables increased per capita consumption and leisure. But capital can accumulate only if adequate savings are available to finance it. And of course, one can save only by consuming less than one earns – that is, by demanding less from others than what one supplies to others. Consumption is thus a consequence, not a cause, of growth.⁷ But for decades Australians have consumed more than they have produced. Accordingly, for years "the fundamentals" of the Australian (and

⁷ One of the greatest fallacies of our gilded age is the exalted status of consumption relative to savings, investment and production. Mainstream economists relentlessly allege (and politicians and journalists ubiquitously parrot) that consumption is the engine of economic growth. They assert, in effect, that consumers do the world a favour by graciously consuming the goods that others produce. If consumers weren't so generous – that is, if a "deficiency of aggregate demand" occurred, then the unemployment of producers would result. Commentary often describes consumption as if it were hard work, "heavy lifting" or otherwise a meritorious and benevolent activity. Consumption, in short, allegedly creates demand for production.

This, of course, has things exactly back-to-front. The modern world no more depends upon consumption than medieval serfs depended upon the consumption of the lords who typically confiscated a quarter of serfs' production. Hence the mainstream ignores the *reductio ad absurdum*: what a disaster for the serfs if their lords had not exacted this tribute! Think of all the unemployment that serfs would have suffered had they not had to toil so hard for the "benefit" of their lords' consumption!

The truth is that, in both the medieval and modern worlds, the able-bodied man who consumes but does not produce is a parasite. In a free society you can demand only to the extent that you can supply; in other words, your ability to supply finances your *effective* demand. *Unfinanced* demand created by the central bank's relentless inflation, on the other hand – that is, the increase of the supply of money not backed by savings – is simply a drain on the productive efforts of some by the recipients of the paper.

American, British, etc.) economy have NOT been sound. Quite the contrary: they have been precarious. A dodgy vehicle, particularly when its demented driver stridently denies that it's unsafe, will eventually crash.

As a second theme of our communications, we have emphasised that central banks' monetary policies have long been as misguided as they are damaging. Central banks' *raison d'être*, it seems, is to lower the rate of interest that they have commandeered (which in Australia is called the Overnight Cash rate, the rate at which banks borrow and lend bank reserves) well below the level that would prevail in a free market. Policy makers do their best to ensure, in other words, that interest rates cannot do their traditional job of harmonising and equilibrating the behaviour of borrowers and lenders. They create a wedge between borrowers and lenders by imposing upon them short-term rates that do not tell the truth about time and risk. As a result of a complex series of developments, mortgage and other rates have also fallen to artificially and dangerously low levels.

Why dangerously? Intervention in credit markets induces borrowers and lenders alike to commit egregious and painful mistakes ("malinvestments"). In particular, vast amounts of artificially-cheap credit have enabled people, businesses and governments to borrow much more (and on far more lenient terms) than they could in a free market. This has created a widespread dependence upon debt, a "borrow now, repay later" mentality and the near-disappearance of the "save for a rainy day" ethos that served our forebears so well. The explosion of credit created from thin air rather than hard savings has inflated the prices of the things that people have used the credit to buy. Hence the third theme of our Annual and Half-Year reports, newsletters, etc.: thanks to poor public policy, dangerous bubbles have long existed – and today remain – in markets for stocks, bonds, and real estate.

After Two Years of "GFC," We Remain as Bearish as Ever

For decades, governments have pursued poor fiscal and monetary policies. These policies caused the GFC, and since mid-2007 they have become far worse. How have politicians and their advisers (who saw nothing coming) reacted to a crisis caused by inflation and its consequences – too much debt and consumption relative to income and savings, artificially low rates of interest, high prices of stocks and bonds, and feeble saving? By vastly increasing governments' indebtedness, suppressing rates of interest even further, urging individuals and businesses to borrow and spend themselves into even deeper holes, rewarding speculators and denigrating saving and frugality! How have they achieved these consequences? By escalating their cause: the central bank's policy of inflation. Moreover, by emphatically denying any responsibility for the crisis – indeed, by brazenly claiming that their "stimulus" has alleviated and will cure it – and by protecting and rescuing well-connected friends, rulers have broadened and deepened the dangers of "moral hazard."

A crisis caused by government intervention has spurred vastly greater government intervention. And thus intervention, in turn, has stoked the fire of another crisis. Politicians and econocrats have moved heaven and earth to slow, delay, shorten and obfuscate today's reckoning – at the cost of deepening and lengthening tomorrow's. By pushing "real" (that is, net of CPI) interest rates below zero, for example, central banks are distorting anew every investment decision. If mispriced debt helped to trigger Act I of the narrowly-averted destruction of global finance, then the "monetary stimulus" enacted since mid-2007 has set the stage for Act II. In the meantime, ultra-low rates have reignited stock and debt markets. Yet whether or not the "stimulus"⁸ stops, the natural order of things remains unaffected. The boom, in other

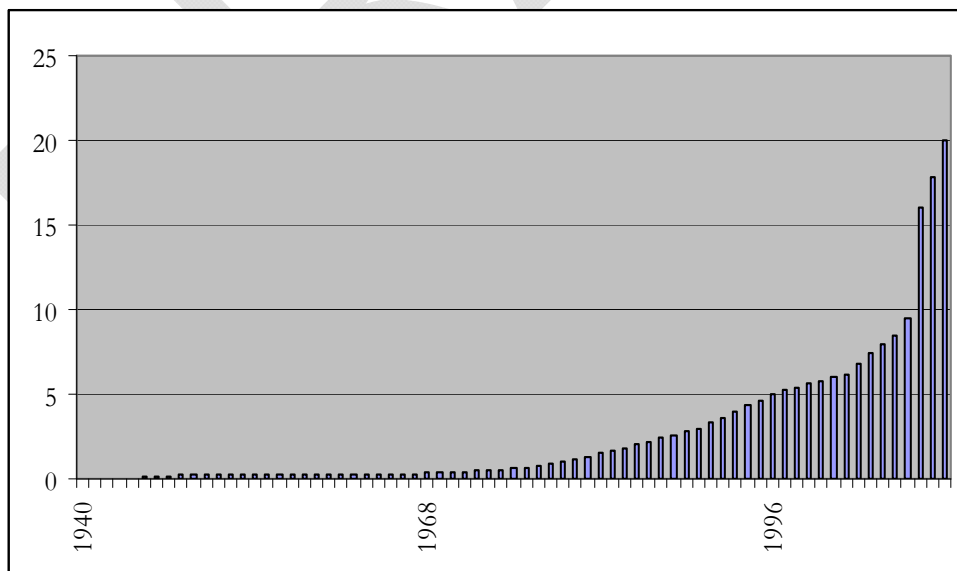
⁸ We define fiscal stimulus as the cumulative increase (as a percentage of GDP) of the federal budget, and monetary stimulus as the cumulative change in the central bank's balance sheet, both measured from the peak of the boom to

words, causes the bust; more generally, and try as they might, governments cannot abolish the laws of economics. Accordingly, debt will be purged one way or another; consumption will fall to a level commensurate with income; interest rates will rise and the prices of stocks, bonds and real estate will consequently fall.

Because it will eventually embrace us, we must accept rather than resist the bust. It's hardly fun, but it's necessary in order to address the real problem – central banks and their policy of inflation. The inflation that ignites the boom sends false signals to markets, namely that there exist sufficient savings to support higher levels of investment. Because no actual increase of savings occurs (indeed, during the Great Bubble the propensity to save fell drastically) these higher levels of investment are unfunded and the higher profits they generate are unsustainable. Like the razing of a house built upon a rickety foundation, the liquidation of “malinvestments” in capital, land and labour is a necessary precursor of sound reconstruction. A sound economic expansion, which is financed by actual savings, does not beget a bust. Only the inflation-induced variety ignited by central banks sows the seeds of its own destruction.

These insights fly in the face of the modern thinking that regards the business cycle as the inevitable result of some inherent flaw in capitalism. This thinking mistakenly believes that the government can mitigate or even prevent recessions, and never sees that intervention in markets by governments is the source of economic and financial instability. *Cycles of boom and bust, we have said repeatedly for a decade, are NOT inevitable and are NOT inherent in the free market economy. Without the inflationary monetary policies of the central bank – which is a creature of the state and not the free market – cycles of boom and bust would not occur.* Mainstream economists regard the alleged “overinvestment” that occurs during booms as mistakes made by businesses, but they never ask why mistakes were committed. As Ludwig von Mises showed, during the boom businesses do not recklessly “overinvest;” instead, they respond to the false economic signals emitted by the central bank’s inflation.

Figure 11:
America’s “On Balance Sheet” National Debt (Trillions of \$US)



the trough of the bust. Since mid-2007, the fiscal stimulus in major Western countries has totaled ca. 10% of GDP and monetary stimulus at least 9.5% of GDP, making a cocktail equivalent to ca. 20% of GDP.

Let us therefore hope that there will be no recovery – at least in the sense that the crowd and its rulers crave it. The mainstream does not yearn for a return to genuine financial and economic health – that is, an economy where the savings and entrepreneurship generated in a free market underwrite the production that finances prosperity. Nor do they want a financial sector which dispenses credit according to character and thereby prices risk cautiously. The crowd and government desire a return to the *status quo ex ante*. They demand, in other words, the modern equivalent of bread and circuses: a debt-financed orgy and consequent series of asset bubbles.

Our Enemy, the State

Alas, the risk is growing that such a “recovery” will, at least for a time, occur. Since mid-2007, central banks’ balance sheets (and hence the potential supply of money) have expanded at unprecedented speeds. Similarly, if we take politicians’ intention to borrow at face value, then during the next decade the supply of government bonds will grow at a pace that exceeds anything ever seen. We doubt that individuals and corporations will be willing and able to absorb such a vastly increased supply at currently-prevailing prices. That means central banks and treasuries will do so; and that, in short, means even more inflation.

In a statist world, perceptions about sovereign creditworthiness calibrate the world’s economic and financial thermostat. For decades the conviction has been wide, deep and seemingly impregnable: U.S. Treasury securities are the planet’s safest credit risk. The yield of a Treasury bill has been the benchmark (or “risk-free”) rate of return; and other assets (ranging from American corporate bonds to European stocks to New Zealand real estate) are priced, if only indirectly, relative to its yield. In recent years, the yields of Treasury bills and bonds have stood at or near historical lows. From the mid-1990s to mid-2000s, these ultra-low yields helped to spawn what by venerable standards were very high – and, in retrospect, dangerously high – asset prices. But what if (as we believe) these yields remain far lower than they ought to be? What if, ironically, the “risk-free” rate is actually fraught with risk (one wag has dubbed Treasury securities “rate-free risk”), and Uncle Sam’s sovereign credit rating vastly overstates his creditworthiness? If so, then a disturbing possibility presents itself: in the not-too-distant future this rating will be downgraded – conceivably to “junk” levels.⁹

⁹ Figure 11 shows the U.S. Government’s “on balance sheet” liabilities – that is, those which appear in its financial statements in some form or another. This comprises the national debt of ca. \$11.2 trillion accumulated since 1789 and the bailouts, stimulus packages etc., of \$11.6 trillion enacted since mid-2007. Adding its “off balance sheet” obligations (i.e., Medicare, Social Security and pharmaceutical liabilities that will be incurred in the years to come, plus the obligations of state and local governments), the present value of U.S. governments’ total net liabilities is ca. \$80 trillion. Higher taxes will offset part of this burden. But that’s the point: massive increases of tax will be required in order to service – or draconian cuts of benefits will be necessary in order to reduce – these obligations (see also [Is the United States Bankrupt?](#) by Laurence Kotlikoff).

In a research report released on 22 March 2005 – that is, more than two years before the eruption of the GFC – and entitled *In The Long Run, We Are All Debt: Aging Societies and Sovereign Ratings*, Standard & Poor’s concluded that unless they move quickly and forcefully to balance their budgets and reduce their spending, spiralling pension and medical expenditures will within 30 years reduce the debt of the world’s richest industrialised countries to “junk” status. If current policies remain unchanged (since 2005, of course, they’ve become far more profligate) then the sovereign debt of France, presently rated AAA (the highest possible rating) will become “junk” (i.e., plummet to a sub-investment grade of BBB minus or less) by the early 2020s; that of the U.S. and Germany will do so before 2030 and the UK will follow by 2035. For details, see *The Intelligent Australian Investor* (John Wiley & Sons, 2005, chap. 4) and [Avoid the Rush](#) by Chris Leithner. And Barron’s (28 September 2009) adds that a sovereign default by Japan “is not only possible but likely, some experts say. Can that once-thriving nation be saved?”

In most Western countries, individuals and businesses are responding to signals that governments are trying to muffle or reverse, i.e., they are curbing their appetite for new debt and hastening the repayment of old debt. After 60 years of growth, credit is now shrinking – in the private sector. (Australia is an exception. At the end of July, its banks' loan portfolios totalled \$1.62 trillion. That compares to \$1.47 trillion in July 2008 and \$1.22 trillion in July 2007.) Alas, rulers' profligacy is offsetting subjects' prudence. The [Flow of Funds](#) reports issued quarterly by the Federal Reserve show that since mid-2007 households and businesses have been reducing their indebtedness at an annualised rate of ca. 1.75%. Although it must do much more, America's private sector is slowly restoring its finances to order. In contrast, government is running amok. Since mid-2007 government debt has exploded by 30% per annum. Washington's budget deficit will total \$1.6 trillion this year, and the Congressional Budget Office forecasts that during the next 10 years shortfalls will total \$9.5 trillion (since mid-2007, its revisions have been uniformly upwards). If so, then "on balance sheet" national debt would exceed \$US32 trillion. Clearly, America's fiscal and monetary mess is not just increasing: it is accelerating.

Uncle Sam's worsening economic and financial condition is taking its toll on the \$US. If the Greenback continues its secular swoon, the world may at some point face a reserve currency crisis. How to arrest the fall of the \$US? Stop printing so many of them. How to do that? Stop issuing so many government bonds. How to do that? Slash today's spending by two-thirds. (Is that extremist? It means balancing the U.S. Government's budget at a level which prevailed during the first Clinton administration. What's extremist are the fiscal and monetary policies of the past decade.) The need to act is being delayed because, for now, the fall in the \$US is boosting the nominal prices of stocks, bonds and commodities. But we doubt this can continue indefinitely. At some point, the truth will dawn: a relentlessly falling \$US and gold that continues to rise above \$US1,000 per ounce means that inflation has become intractable. Even *The Wall Street Journal* is nervous. On 17 September it summarised matters thus:

Q: OK, Ben Bernanke put out the financial fires that threatened to burn down the economy. What are his biggest challenges now?

A: One, pick the right time to raise interest rates from today's near-zero level and drain the massive amounts of credit the Fed has pumped into the economy. Act too soon, and he risks provoking another recession. Act too late, and he gets more inflation than he deems prudent.

Q: Given all the [credit] that the Fed has creates, isn't inflation inevitable?

A: ... Having created so much credit, the Fed is taking a big risk that it will get more inflation than it wants. Some observers, citing historical precedent, say an outbreak of inflation is inevitable. Inflation can be avoided only if the Bernanke Fed has the forecasting skill and luck to withdraw credit soon enough, and has the political fortitude before everyone is convinced that the economy is back to something resembling normal.

Q: If the Fed helped to get us into this mess, why put it in charge of preventing the next crisis?

A: If the problem is inherent in the Fed ... then it is destined to repeat the errors of the past.

Q: Are we just supposed to ignore the trillions of dollars of government debt?

A: The US Government has demonstrated that it can borrow seemingly limitless amounts at low interest rates ... But someday, foreign investors will be sated or demand higher interest rates, and the US economy will suffer.

So we're ignoring all the talk that "the worst has passed," "green shoots" are sprouting, "recovery" is nigh, etc. America's (and Britain's, etc.) rulers are trashing their countries' financial position ever more aggressively. The Bush and Obama administrations, for example (which are simply separate wings of a single bird of prey, and whose underlying economic policies are indistinguishable), have subsumed over-leveraged consumer and financial sectors under Uncle Sam's much more overleveraged balance sheet. What has this achieved? For the moment it has blunted and delayed – but as the debt builds it will even-

tually intensify – the pain of deleveraging. Actions have consequences, and the results of governments’ fiscal and monetary recklessness include rising prices, taxes and unemployment, and a longer than anticipated (or “double-dip”) recession.¹⁰

Alan Greenspan – neither a disinterested nor a reliable witness – spies these consequences but flatly denies that his or his successor’s policies caused them. Indeed, on 1 October he praised the steps taken by Ben Bernanke “to help pull the economy out of recession. The Fed has done a splendid job.” Still, he avers, credit conditions must tighten and taxes must rise. Also, the Fed must siphon from the financial system much of the credit it has “injected” since mid-2007. “My concern,” said the Great Inflator and Great Evader of Responsibility, “is that legislation or other actions on the part of Congress may prevent” the Fed’s withdrawal of stimulus. “Unless we sterilise or unwind the big monetary base we’ve built up, two, three years out [the consequences of inflation] really begin to take hold.” Further, although Mr Greenspan praised President Obama, he doesn’t “think he [Obama] is sufficiently in control of a very serious budget problem.”

Prices, taxes, etc., may not begin to rise tomorrow; but once they do their momentum will be very hard to stop. Downplayed in America, Britain, Europe and Japan (and virtually ignored in analyses and debates about Australia’s “stimulus”) is an immutable fact: even under rosy scenarios in most countries including Australia, public sector debt will henceforth rise (perhaps sharply) as a percentage of GDP. Whenever the rate of interest payable on the government’s debt exceeds the economy’s rate of growth, the debt-to-GDP ratio (i.e., the government’s “leverage” or “gearing”) grows.

As an illustration, assume that Australia’s GDP is \$100 and that during a given year it grows by 1% to \$101. (According to the International Monetary Fund’s latest forecasts, Australia’s nominal GDP will grow 0.7% in 2009.) Also assume that at the start of the year the sum of Commonwealth and state debt is \$15, i.e., 15% of GDP (which approximates the present figure), and that its bonds pay an average of 5.5% interest (ditto). Total interest payable at the end of the year is thus $\$15 \cdot 0.055 = \0.825 . In order to pay it, Commonwealth and state governments must either run budget surpluses of this amount (or, equivalently, cut their expenditure during the year by this amount), or borrow it. If they borrow it, then at the beginning of the next year debt increases to \$15.825 and the debt-to-GDP ratio rises to $\$15.825/\$101 = 15.7\%$.

There are two reasons to believe that during the next ten years long-term rates of interest will rise, thereby placing further upward pressure upon the debt-to-GDP ratio. The first is opportunity cost: the funds that governments are borrowing in order to finance their huge and growing budget deficits cannot

¹⁰ Carmen Reinhart and Kenneth Rogoff (“The Aftermath of Financial Crises,” NBER Working Paper No. 14656, January 2009) conclude their analysis of data extending back more than a century that post-crisis downturns tend to be “protracted affairs.” So do Barry Eichengreen and Kevin O’Rourke (“A Tale of Two Depressions”), who show that in economic and financial terms 1929-1931 provides the closest parallel to 2007-2009 (in 1930, leading lights scoffed at the idea that a depression was developing).

In its 2008 annual report, released on 16 August, the Bank for International Settlements reviewed previous banking crises. It concluded that sustainable recoveries from such crises require that the banking system take losses, jettison non-performing assets, eliminate excess capacity and rebuild its capital. Alas, “these conditions are not being met and any stimulus will therefore only lead to a temporary pick up in growth followed by protracted stagnation.” On 17 August the BIS’s former Chief Economist, William White, warned that “the world has not tackled the problems at the heart of the economic downturn and is likely to slip back into recession.” Further, “government actions to help the economy in the short run may be sowing the seeds for future crises.” He also foresaw a double-dip recession: “I would not be in the slightest bit surprised. The only thing that would really surprise me is a rapid and sustainable recovery from the position we’re in.”

finance the replacement and accumulation of private capital. The more that governments borrow, the more they “crowd out” private investment and thereby ensure that the nation’s stock of private capital will be lower than it otherwise would be. Unless one can demonstrate that governments’ “investments” will earn higher rates of return than those that individuals and businesses would have earned with the funds the government borrowed, the government’s borrowing distorts activity from relatively productive and towards relatively unproductive ends, and thereby reduces national income below the level that would otherwise have prevailed. When the state borrows, in short, the pool of funds available for investment in the private sector shrinks. Moreover, the competition for these remaining funds tends to increase lenders’ hand relative to borrowers’ – i.e., to stiffen loans’ terms and conditions, and to increase their rates of interest.

Secondly, rates of interest will rise if lenders expect that the CPI’s rate of increase on a worldwide basis (the Cleveland branch of the Fed produces such an index) will accelerate. This is especially likely to happen if the Fed, Bank of England, Bank of Japan and European Central Bank continue to do what (to greater or lesser extents) they have done over the past year: purchase (“monetise”) public debt with money created, in effect, out of thin air. The staggering amounts of funny-money that have already been pumped into markets by central banks as part of their monetary “stimulus,” together with the additional titanic amounts they must pump in order to finance governments’ current and coming budget deficits, will, we fear, put eventually place strong upward pressure upon the CPI. This occurred around the world after the fiscal and monetary excesses of the 1960s and 1970s, and produced prolonged “stagflation” – that is, a combination of stagnation and inflation.

Having canvassed these grim scenarios, let’s for a moment be optimistic and imagine that within a year the rate growth of Australia’s GDP increases to ca. 3% in real terms and the rate of increase of CPI decelerates to ca. 2% per annum. Even under rosy scenarios, as long as the Commonwealth and states collectively run budget deficits the ratio of public debt to GDP will continue to grow. And if long-term interest rates rise, this ratio will be even harder to stabilise – never mind reduce. Given the profligate policies of American, British, European and Japanese governments, higher interest rates seem very likely, and the more that rates rise the more aggressively the public debt-to-GDP ratio will feed upon itself, requiring more drastic fiscal management than currently anticipated to bring it under control. The Australian ratio of government debt to GDP is relatively low by international standards. But on a per capita basis Australia is one of the world’s heaviest borrowers in international markets. Coupled with the fact that the Commonwealth’s fiscal turnaround (that is, from big surplus to big deficit) has been one of the Western world’s most sizeable in terms of GDP, Australia is very vulnerable.

“Massive government borrowing programs threaten to choke a still-fragile global economic recovery by pushing interest rates higher and reducing available credit for the private sector.” So warned the International Monetary Fund in its latest (30 September) review of what it politely describes as “global financial stability.” Further, although the panic of a year ago has abated, the IMF cautions that the world’s banks are still facing huge bad debts that could yet cause a “double-dip” global recession. The good news is that the IMF lowered its estimate of the total bank write-downs and losses stemming from the GFC from ca. \$US4 trillion to roughly \$US3.4 trillion. The bad news is that less than half of this total loss has thus far been realised, and that the pace of losses is set to rise as unemployment and debt delinquencies continue to increase. IMF also frets that, at a time when governments’ voracious borrowing is commandeering so much savings and creating so much artificial credit, weakened banks, which must purge another ca. \$US1.5 trillion of bad debts from their balance sheets, will be unable to provide business and households with the huge quantity and low prices of credit they’ve come to expect. “Since all credit providers can buy sovereign debt, sovereign issuance will effectively compete with – and possibly crowd out – private sector credit needs.”

The IMF's concerns echo the comments that Glenn Stevens, the RBA's governor, uttered a few days before. "The thing which is most likely to crowd out Australian businesses and other businesses by pushing up the long-term global interest rate – it is not going to be the Australian government's contribution to borrowing, unless it is a lot bigger than it looks like being – it will be the huge run-up in public debt in the major countries, which are quantitatively so much larger."

In the five years before the collapse of the Great Bubble, borrowing in major "advanced" (i.e., deadbeat Anglo-Saxon) countries averaged \$US1 trillion per year. Their borrowing doubled in 2008, will reach \$US3.2 trillion this year and allegedly fall to \$US2.2 trillion in 2010. The IMF said that over the next two years, the total borrowing needs of government and the private sector will (by amounts ranging from 2.4% of GDP in the U.S., 3% in Europe and a whopping 15% in Britain) exceed the ability of the finance sector to supply funds. It's not *despite* the continuing depressed and indebted state of these economies, as the IMF says, but *because of it*, that the pressure upon long-term rates is upwards. "There's no question that the most significant vulnerability as [the world emerges] from recession [sic] is the soaring government debt," Harvard University economist Kenneth Rogoff told Bloomberg on 24 September. "It's very likely that will trigger the next crisis as governments have been stretched so wide." Bloomberg added that even a deceleration of the rate of increase of borrowing "will probably require leaders to raise taxes and cut spending, ushering in what HSBC Holdings' chief economist Stephen King calls an 'age of austerity' that saps growth prospects for years to come."

Hence we remain bearish about the future. The excesses caused by decades of poor policies, which have culminated in the "stimulus" policies enacted since 2007, cannot be purged within a few quarters. Instead, it will take years to realign debt and the capacity of individuals, businesses and governments to service it. During this lengthy and painful process, many people will belatedly realise that they do not own houses (or other debt-financed "assets"); instead, they will at last understand that their debt owns them. We expect that the next decade will resemble the 1970s rather than the 1930s or the 1990s. It may well include an extended period of stagnation or recession and falling asset prices, together with rising consumer prices and rates of interest ("stagflation"). The results of the poor (i.e., interventionist) policies of the past have returned to the roost, and the growing clamour for yet more intervention will merely strengthen the downdraught.

Some General Scenarios for the Future

Can the past intelligently inform our expectations about the future? For the moment, let's set our dour outlook to one side and examine average investment results over varying periods of time. Assume that your portfolio perfectly mirrors the Standard & Poor's 500 Index. What return can you expect it to earn over periods of one, five, ten and 20 years? Of the average return, what portion comes from increases in the prices of stocks and what portion from dividends? And what has been the impact upon returns of the rise of the Consumer Price Index?

Table 1 answers these questions.¹¹ It summarises all of the 1,662 12-month intervals between January 1871 and June 2009 (i.e., January 1871-January 1872, February 1872-February 1873, ... and June 2008-

¹¹ Chris reanalysed the dataset compiled by Robert Shiller for his book *Irrational Exuberance* (Princeton University Press, 2000 and subsequent editions). Updated monthly, it contains a wealth of data about the S&P 500, its level, earnings, dividends, etc. No comparable Australian data are publicly available; hence we must cross our fingers and assume that these American results apply to Oz. This assumption seems reasonable: according to the *Credit Suisse Global Investment Returns Yearbook 2009*, compiled by Elroy Dimson, Paul Marsh and Mike Staunton of London Business School, average Australian returns since 1900 are among the highest in the 19 countries they analyse, and are generally higher than those in the U.S.

June 2009), of all 1,602 possible five-year results, etc. It defines total investment return as the sum of two components: capital appreciation and dividend. It expresses total investment return and its components in “nominal terms” (i.e., ignoring the Consumer Price Index) and in “real” terms (that is, net of the CPI). They show that compound total returns of 8.5-10.0% per annum (in nominal terms) and 6.5-7.5% per annum (in real terms) are the norm.

Table 1:
Returns (Compound pa), Standard & Poor’s Index, January 1871-June 2009

	Unadjusted for CPI			Adjusted for CPI		
	Capital Return (Nominal)	Dividend Return (Nominal)	Total Return (Nominal)	Capital Return (Real)	Dividend Return (Real)	Total Return (Real)
All 1-Yr Pds	4.52%	5.49%	10.01%	3.15%	4.62%	7.78%
All 5-Yr Pds	4.44%	4.79%	9.23%	2.27%	4.74%	7.01%
All 10-Yr Pds	4.51%	4.81%	9.32%	2.23%	4.71%	6.94%
All 20-Yr Pds	4.47%	4.88%	9.35%	1.99%	4.77%	6.76%
Jan 1871-Jun 2009	3.93%	4.79%	8.72%	1.88%	4.63%	6.51%

Table 1 confirms a tenet of sound investing: the longer is the time horizon, the more important is the dividend’s contribution to the total return. The present value of a portfolio reflects the present value of the stream of dividends it can reasonably be expected to emit. In contrast, the present value of (eventual) capital appreciation dwindles over time. To see this, look down the two “capital return” columns and observe that the percentages decrease as the investment horizon lengthens. In contrast, the figures in the dividend return columns tend to increase. As a result, the dividend return relative to total return rises as the investment horizon expands. On average over all one-year periods, real dividends comprise $4.62 \div 7.78 = 59\%$ of the total real return. Over all five-year and ten-year intervals, dividends comprise 68% of the total return, and over all 20-year periods they contribute 71%.

Nominal returns exceed real returns. Specifically, the CPI (whose annual increase has averaged 2.2% since 1871) is equivalent to a flat tax of $2.23 \div 8.72 = 25\%$ upon returns. *CPI harms nominal returns by reducing capital returns; but it does not, by and large, harm the value of dividends.* To see this, compare capital returns within each row. Over one-year periods, the average capital return is 5.21% (unadjusted) and 3.15% (adjusted); over five-year periods, it is 4.44% (unadjusted) and 2.27% (adjusted), etc. Over all time horizons, adjusted capital gains are significantly lower than unadjusted capital gains. Now compare dividend returns within each row. Over one-year periods, the average return is 4.49% (unadjusted) and 4.62% (adjusted); over five-year periods, the average is 4.79% (unadjusted) and 4.74% (adjusted), etc. Over all time horizons, the adjusted dividend returns are not significantly lower than the unadjusted capital returns. *The more our total investment return derives from dividends, in other words, the less the CPI will trash it over time.*

What about the variability of returns? Let us record each one-year total investment return and its components in both nominal and real terms. Let us sort then this array of 12-month returns from highest to lowest according to the total real return; divide this sorted list into “quintiles,” i.e., five groups which each contain an equal (net of rounding) number of observations; and finally, within each quintile, com-

pute the mean of each type of investment return.¹² The results of this exercise appear in Table 2. Results of similar exercises, using five-year and ten-year returns, appear in Tables 3-4.

Table 2:
The Variability of One-Year Returns,
Standard & Poor's Index, January 1871-June 2009

	Unadjusted for CPI			Adjusted for CPI		
	Capital Return (Nominal)	Dividend Return (Nominal)	Total Return (Nominal)	Capital Return (Real)	Dividend Return (Real)	Total Return (Real)
Quintile A	28.09%	5.59%	33.67%	27.27%	5.56%	32.83%
Quintile B	14.03%	5.43%	19.46%	11.92%	5.37%	17.28%
Quintile C	3.43%	4.48%	7.91%	2.61%	4.48%	7.09%
Quintile D	-3.05%	4.60%	1.55%	-6.75%	3.96%	-2.79%
Quintile E	-19.86%	3.74%	-16.12%	-22.91%	3.60%	-19.31%

Table 3:
The Variability of Five-Year Returns (Compound pa),
Standard & Poor's Index, January 1871-June 2009

	Unadjusted for CPI			Adjusted for CPI		
	Capital Return (Nominal)	Dividend Return (Nominal)	Total Return (Nominal)	Capital Return (Real)	Dividend Return (Real)	Total Return (Real)
Quintile A	13.85%	5.30%	19.15%	12.53%	5.48%	18.01%
Quintile B	7.61%	4.90%	12.52%	5.95%	4.84%	10.79%
Quintile C	4.15%	4.57%	8.71%	2.47%	4.51%	6.98%
Quintile D	0.19%	4.96%	5.14%	-2.26%	4.82%	2.57%
Quintile E	-4.61%	4.17%	-0.44%	-8.52%	3.98%	-4.54%

Table 2 shows that, in both nominal and real terms, total one-year returns vary drastically from year to year. There's a one-in-five chance of a total gain of more than 30% (Quintile A); but there's also a one-in-five chance of a total loss of more than 15%. Indeed, in real terms, there's a 40% chance (Quintiles D and E) that in any given 12-month interval a loss will be incurred. Total returns (real and nominal) are variable because capital returns (real and nominal) are variable. In nominal terms, they vary a whopping 49.8 percentage points from the highest to the lowest quintiles, and in real terms they vary 52.1% percentage points. In sharp contrast, dividend returns are remarkably constant. Whether the total return is excellent (Quintile A) or abysmal (Quintile E), dividend returns vary by less than two percentage points. Clearly, the greater the dividend as a percentage of one's total return, the more stable – and positive – that return will be.

¹² For further details of this method, which has a rather long history in financial analysis, see Francis Nicholson, "Price-Earnings Ratios in Relation to Investment Results," *Financial Analysts Journal* (January-February 1968); David Dreman, *Contrarian Investment Strategies: The Next Generation* (Simon & Schuster, 1998), and James P. O'Shaughnessy, *What Works on Wall Street* (McGraw-Hill, 1998).

Table 4:
The Variability of Ten-Year Returns (Compound pa),
Standard & Poor's Index, January 1871-June 2009

	Unadjusted for CPI			Adjusted for CPI		
	Capital Return (Nominal)	Dividend Return (Nominal)	Total Return (Nominal)	Capital Return (Real)	Dividend Return (Real)	Total Return (Real)
Quintile A	10.85%	5.08%	15.92%	8.86%	5.00%	13.85%
Quintile B	6.06%	4.87%	10.94%	4.95%	4.85%	9.80%
Quintile C	3.88%	4.64%	8.52%	2.31%	4.58%	6.89%
Quintile D	1.56%	4.81%	6.36%	-0.72%	4.69%	3.98%
Quintile E	-0.79%	4.61%	3.82%	-5.73%	4.38%	-1.35%

Tables 3-4 show that these results also apply over five- and ten-year intervals. The longer the interval, the less is the fluctuation of the total return. Yet in both nominal and real terms, total five-year returns continue to vary considerably. In any random-selected five-year interval there's a one-in-five chance of a total gain of more than 15% (Quintile A), and also a one-in-five chance of a loss (Quintile E). Indeed, in real terms there's a 20% chance of a loss over five and ten years. The once-unshakeable belief that stocks become virtually riskless over the "long term" (which over the years has ceased to imply decades and now means just a few years), popularised by seminal books like Jeremy Siegel's *Stocks for the Long Run* (McGraw-Hill, 2002) and James Glassman and Kevin Hassett's *Dow 36,000: The New Strategy for Profiting From the Coming Rise in the Stock Market* (Three Rivers Press, 2000) and which recent events have shown is highly questionable, never was true.

Table 5:
One-Year Returns Stratified by CPI
Standard & Poor's Index, January 1871-June 2009

	Unadjusted for CPI			Adjusted for CPI		
	Capital Return (Nominal)	Dividend Return (Nominal)	Total Return (Nominal)	Capital Return (Real)	Dividend Return (Real)	Total Return (Real)
Mean CPI 10.66%	2.88%	5.20%	8.08%	-6.88%	4.69%	-2.19%
Mean CPI 3.66%	7.85%	4.22%	12.07%	4.29%	3.62%	7.91%
Mean CPI 2.10%	16.48%	4.21%	20.70%	14.11%	4.13%	18.23%
Mean CPI -0.05%	2.50%	4.90%	7.40%	2.61%	4.91%	7.52%
Mean CPI -6.73%	-5.38%	5.54%	0.16%	1.37%	5.97%	7.34%

Total returns (real and nominal) in the medium and long term fluctuate because capital returns (real and nominal) fluctuate. They do so less in Table 3 than in Table 2 (and less in Table 4 than in Table 3), but they continue to vary far more than dividend returns. In nominal terms, capital returns vary by 18.5 percentage points from the highest to the lowest quintiles, and in real terms they vary 21.0 percentage

points. In contrast, returns from dividends remain remarkably constant: indeed, they are more constant in Table 3 than in Table 2 (and more constant in Table 4 than in Table 3). Whether the total return is excellent (Quintile A) or abysmal (Quintile E), dividend returns vary by ca. 1.5 percentage points in Table 3 and by less than one percentage point in Table 4.

We can say more about the CPI's impact upon investment results. Let us sort the array of one-year investment returns from highest to lowest according to the rate of change of the CPI; divide this sorted array into quintiles; and finally, within each quintile, compute the mean of each type of investment return. The results of this exercise appear in Table 5. Results of similar exercises using five-year and ten-year returns appear in Tables 6-7.

**Table 6:
Five-Year Returns (Compound pa) Stratified by CPI
Standard & Poor's Index, January 1871-June 2009**

	Unadjusted for CPI			Adjusted for CPI		
	Capital Return (Nominal)	Dividend Return (Nominal)	Total Return (Nominal)	Capital Return (Real)	Dividend Return (Real)	Total Return (Real)
Mean CPI 7.47% pa	3.31%	5.27%	8.58%	-3.80%	4.90%	1.10%
Mean CPI 3.64% pa	7.47%	4.08%	11.55%	3.70%	3.93%	7.63%
Mean CPI 2.24% pa	6.48%	3.96%	10.44%	4.16%	3.87%	8.03%
Mean CPI 0.48% pa	7.77%	5.19%	12.96%	7.26%	5.37%	12.63%
Mean CPI -3.52% pa	-3.45%	5.52%	2.07%	0.04%	5.73%	5.77%

Periods when the CPI is “low” (which the mainstream defines as an increase of ca. 2% per year) are most conducive to strong investment returns. Conversely, periods when CPI either rises or falls rapidly (Quintiles A and E) are least favourable to strong returns and most likely to produce capital losses. The 12-month periods in Quintile C, during which the CPI increased an average of 2.1%, show average nominal returns of 20.7% and average real returns of 18.2%. Also, notice that capital growth provides the bulk (80% in nominal terms and 77% in real terms) of these returns. Quintiles B and D, in which CPI increased an average of 3.66% and declined an average of 0.05%, respectively, also provide good nominal and real returns; in these quintiles, however, dividends comprise ca. two-thirds of the total nominal and real return.

Investors beware: years when the CPI soars are years when investors suffer losses. In Quintile A of Table 5, which comprises that 20% of 12-month periods when CPI rose most rapidly (by an average of 10.66%), stocks increased an average of 2.88% in nominal terms but fell 6.88% in real terms. Although dividends increased 4.69% in real terms, the loss of capital was enough to incur an overall loss of 2.19% in real terms. Spurred by extremely strong capital growth, the largest investment returns tend to occur in years when the CPI rises by ca. 0.5-3.5%, and losses arise when CPI exceeds this threshold. More generally, stable consumer and producer prices beget strong rises of the prices of stocks; monetary disturbances, on the other hand, which cause the level of consumer prices either to rise or fall

appreciably, are associated with a stagnation and decrease of stock prices. In contrast, regardless of the rate of change of CPI, the return from dividends (nominal and real) is remarkably constant.

Table 7:
Ten-Year Returns (Compound pa) Stratified by CPI
Standard & Poor's Index, January 1871-June 2009

	Unadjusted for CPI			Adjusted for CPI		
	Capital Return (Nominal)	Dividend Return (Nominal)	Total Return (Nominal)	Capital Return (Real)	Dividend Return (Real)	Total Return (Real)
Mean CPI 6.51% pa	2.75%	5.78%	8.53%	-2.38%	5.49%	3.11%
Mean CPI 3.82% pa	7.86%	4.44%	12.30%	3.93%	4.25%	8.18%
Mean CPI 2.43% pa	6.01%	3.94%	9.95%	3.49%	3.85%	7.34%
Mean CPI 0.58% pa	5.44%	4.90%	10.34%	4.83%	4.88%	9.71%
Mean CPI -2.47% pa	-0.49%	5.45%	4.96%	2.06%	5.58%	7.64%

Some Bearish Scenarios for the Future

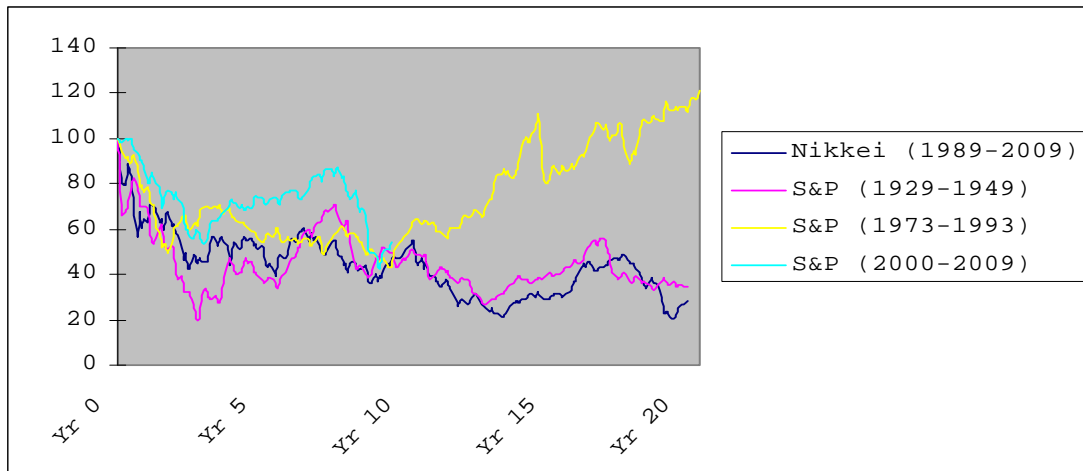
Let's now return to our bearish outlook. What do past recessions and bear markets tell us about what the present recession and bear market (which is how we characterise the present, even though practically nobody else does) might hold in store? Figure 12 depicts four of the most severe bear markets of the past century: the Great Depression (as measured by the S&P 500 Index between September 1929 and September 1949); the oil shock and stagflation of the 1970s (S&P 500 between March 1973 and March 1993); Japan's "Lost Decades" (Nikkei from April 1990 to June 2009); and the Internet Bubble-Great Bubble (S&P 500 since March 2000). All four series begin at an epochal market maximum, and all except the most recent cover 20 years. Further, each series has been discounted by the CPI and standardised to a common starting value of 100.

The most basic result is hardly surprising: bear markets can last a seemingly interminably long time and inflict cumulatively and unexpectedly brutal punishment upon investors. But no bear is the same. Which was the worst? That depends, among other things, upon the interval of time under consideration. The descent of the Nikkei has inflicted the severest punishment over the longest interval: a portfolio that mimics it fell from 100 in 1990 to 28 in June 2009 – that's a cumulative loss of purchasing power of 72%. Year after year for 20 years, in real terms the Nikkei has fallen at a compound rate of 6.3% per annum. Since 2000, the S&P 500 has fallen from 100 to 55, i.e., at a compound rate of 6.2% per year; and between 1929 and 1949, it fell from 100 to 34, or by 5.5% per year in real terms. Only from 1973 to 1993 did it increase – from 100 to 121, a compound rate of 0.8% per year in real terms.

Which was the worst bear market? Over five or fewer years, the Great Depression took the prize. In real terms, the S&P 500 collapsed 80% in fewer than three years. Over that interval, the Nikkei plunged merely 57% over 3½ years, from 1973 to 1975 the S&P 500 fell by 50%, and from 2000 to 2003 it decreased by 45%. After ten years, each inflicted roughly the same (45-55%) amount of cumulative damage, equivalent to a compound rate of decrease of 6.5% per year for ten years. It's vital to appreciate, in

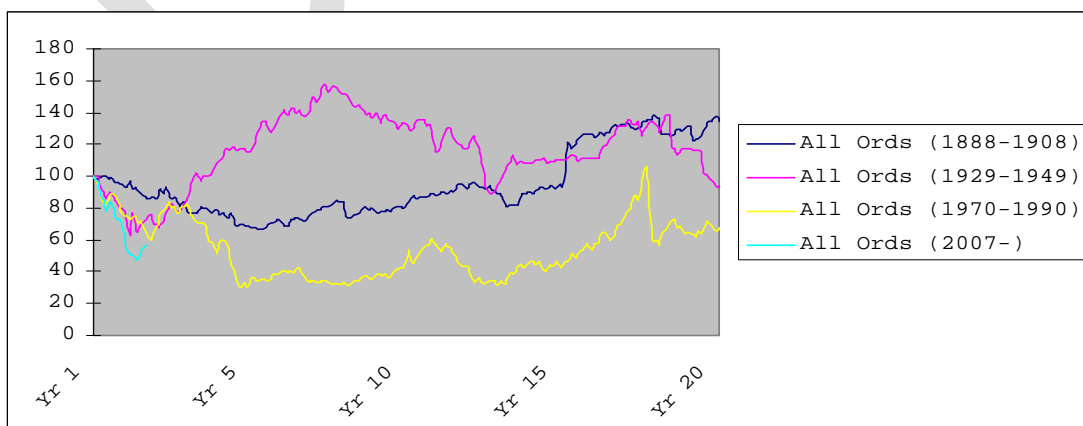
the light of stock markets' sharp upward trajectory since March 2009, that each of these long bears was punctuated by the false dawn of sharp bear market rallies (Table 8). On seven occasions since 1989, the Nikkei has risen by at least 30% within six months. In 1929-49, the S&P 500 did so no less than 12 times; between 1973 and 1993, it did so on three occasions; and since 2000 it has done so once. But it was all to no avail. To put it mildly, these false dawns should (but probably won't) temper the bulls' enthusiasm about the rise of Australian and other market indexes since March of this year.

Figure 12:
Some Epochal Overseas Market Highs and Their Aftermaths



What does the future hold? Figure 12 suggests two possibilities: one is merely bad, and the other is much worse. The merely bad possibility conforms roughly to years 11-20 of the series that commenced in 1973. If so, then it recoups most of its losses and regains the 100 barrier – but still records a 20-year re- turn, net of CPI, which fails to match the average cash rate during that 20-year interval. The much worse possibility is that it conforms roughly to years 11-20 of the Nikkei series that commenced in 1990 and the S&P series that began in 1929. If so, then for years it grinds in a generally negative direction and cumu- latively destroys the bulk of a portfolio's purchasing power.

Figure 13:
Some Epochal Australian Market Highs and Their Aftermaths



Do these results apply to The Lucky Country? Figure 13, which depicts the four most severe bear markets in Australian history, suggests that they could. These bear markets are the Depression of the 1890s (as measured by the AOI between November 1888 and November 1908); the Great Depression of the 1930s (AOI July 1929-July 1949); the Whitlam-Fraser stagflations of the 1970s and 1980s (AOI January 1970-January 1990); and the Great Bubble (AOI since October 2007). Again, all four series begin at an epochal market maximum, and all except the most recent bear cover 20 years. Further, each series has been discounted by the CPI (for the first series, the Melbourne producer and consumer indices compiled between 1855 and 1925) and standardised to a common starting value of 100.

As it was overseas, so too in Australia: the major bust caused by the major boom lasts a long time. Which was the worst bear market? Again, that depends upon the length of time under consideration. The 1970s-1980s inflicted the severest punishment over the longest interval: a portfolio that mimicked the AOI during the 20 years from January 1970 fell from 100 to 67 – a cumulative loss of purchasing power of 33%. Year after year for 20 years, in “real” (as opposed to “nominal”) terms the AOI fell at a compound rate of 2.4% per annum. Between 1929 and 1949, it fell from 100 to 94, or by 0.5% per year in real terms. Between 1888 and 1908, it rose from 100 to 135, or by 1.5% per year in real terms. From October 2007 to June 2009 (it’s early days yet), the AOI fell in real terms from 100 to 57, i.e., at a compound rate of 24.5% per year.

Which was the worst bear market? Over two years, the most recent (Great Bubble) is the worst; and over three years, the 1890s, 1930s and 1970s were equally bad. Over longer periods of time, the AOI recovered erratically but reasonably gradually 5-15 years after the market maximum in 1888. The 1930s and 1970s series behaved very differently. The AOI rose very strongly (from 70 to 160) from 1931 to 1936; thereafter, however, it fell to 90 by 1941, rose to 130 by 1947 and then relapsed again (to 94 in 1949). Each time, a galloping CPI did the damage. Indeed, if the series that ended in 1949 had been extended to 1954, it would have closed at 48. That’s a cumulative investment loss of more than 50% over 25 years.

**Table 8:
Bulls Beware! Short and Sharp Rallies Routinely Occur
During Long Bear Markets**

	No of Market Rises of 20%+ Within 6 Mo	No of Market Rises of 25%+ Within 6 Mo	No of Market Rises of 30%+ Within 6 Mo
All Ords 1888-1908	0	0	0
All Ords 1929-1949	5	3	1
All Ords 1970-1990	44	25	16
Nikkei 1989-2009	23	16	7
S&P 500 1929-1949	29	22	12
S&P 500 1973-1993	26	9	3

Few know that the 1970s damaged Australian portfolios much more brutally than the 1930s. The All Ordinaries Index fell from 100 in 1970 to 30 late in 1974, and remained in the low-30s until 1983. It then rocketed upwards, breaching 100 in 1987, and shortly thereafter collapsed by almost half. In 1990, it stood at 67 – thereby inflicting a cumulative decrease of 33% upon investors’ purchasing power. As in Japan and the U.S., so too in Oz (particularly in 1970-1990): bear markets other than 1888-1908 were

punctuated by the false dawns of numerous sharp bear market rallies. As it is overseas, so it is in Oz: the more severe is the bear market, the more numerous are the bear market rallies and the dispiriting false dawns they create.

What does the future hold for today's All Ords? If the Great Bubble burst and a long-term bear market commenced in October 2007,¹³ then Figure 13 suggests three possibilities: one is bad in the long term but very good in the medium term; and irrespective of the interval of time, the second is ugly and the third is horrendous. The first possibility – which the vast majority of today's market participants seem to regard as a strong favourite – resembles the AOI's trajectory from 1931 to 1936: that is, a very sharp increase that recoups all of the losses incurred during the bust, and also adds significant gains. The second possibility is that the future reprises the 1890s bear market, namely a very long (15 year) slog that recoups the losses of the bust but adds no gains. It's ironic that the horrendous possibility, which occurred within the lifetimes of many of today's investors, is the one that virtually everybody ignores. If the AOI's subsequent trajectory looks anything like years 5-10 of the bear market that commenced in 1970 then during the next several years Australian investors will suffer dreadful losses. If the 1970s is our future, then the AOI will breach the "low" of March 2009 (3,250) and eventually fall to ca. 2,200 (see also Leithner Letter 114-116). Adding insult to injury, in 12-17 years – that is, in the mid-2020s – in CPI-adjusted terms investors will have recouped few of the losses incurred since late 2007.

What Would Ben Graham Say About Today's Market?

Has the Worst Passed? Let's Hope Not!

It happens repeatedly: upon reflection, we conclude that what we initially thought was good news is actually bad. Similarly, what we at first regarded as bad news occasionally has a sufficiently thick silver lining that it qualifies as good. If, for example, "stimulus" is actually poison, then one day Australians will curse it as fervently as they presently embrace it. And if a recession and accompanying bear market is actually the necessary and unavoidable means by which poor policies are repudiated, debt purged and savings rebuilt, then one day Australians will welcome it as a necessary condition of genuine recovery.¹⁴ Hence Ben Graham counselled that the investor must analyse rather than emote; he must neither rejoice at "good" news nor despair at "bad" news. At the same time, to the extent that his reason cannot suppress them, the investor should retrain his emotions so that they diametrically oppose the crowd's. In other words, he should be fearful when the crowd celebrates and exultant when it cowers. Graham rec-

¹³ Ed Easterling (*Unexpected Returns: Understanding Secular Stock Market Cycles*, Cypress House, 2005) has become the standard reference for regarding March 2000 as the end of America's most recent secular bull market and the start of a secular bear market. Adapting Easterling's criteria to Australian conditions yields the conclusion that in Australia the Great Bubble popped in October 2007.

¹⁴ According to Jose A. Tapia Granados and Ana Diez Roux, a depression does more for longevity than diet or exercise. Life expectancy during the worst years of the Great Depression increased from 57.1 years in 1929 to 63.3 years in 1933. It didn't matter whether you were a man or a woman, or black or white; and it didn't matter if you resided in the US or in Spain, Japan or Sweden during their economic downturns. By contrast, life expectancy declined during the boom years. For most age groups, "mortality tended to peak during years of strong economic expansion (such as 1923, 1926, 1929 and 1936-1937)," they wrote in the September 2009 issue of *The Proceedings of the National Academy of Sciences*.

Conventional wisdom holds that recessions are times of stress. People do not eat well, and they skip medical check-ups. Hence they should drop dead sooner. Instead, they live longer. Perhaps as the economy crashes, people live at a more comfortable pace. Maybe the unemployed get more sleep. We don't know. But if you want to live an extra six years, nothing works like a slump. And when it comes to economic health too, one must take one's medicine. The drug junkie must eventually undergo detoxification; similarly, the debt junkie must eventually submit to a depression.

ognised that our heart is not a tap that we can (or even should) turn on and off. But if he was correct, in matters financial it should be a course of water whose direction our head can sometimes reverse.

Since the first week of March, stock market indices around the world have risen by 40-50%. In the autumn a wave of relief swept the crowd, during the winter it began to rejoice and now that spring has sprung the conviction has appeared: the worst has allegedly passed, “green shoots” are supposedly sprouting and before too long all will once again be well. If he were here today, it’s very unlikely that Ben Graham would share these sentiments. Graham was a keen and lifelong student of Classics (upon his graduation, Columbia University offered him a chair in his choice of Classics, English or Mathematics; he declined them all in order to go to Wall Street). Not surprisingly, he regarded “the investor’s chief problem – and even his worst enemy – [as] himself.”

To know oneself is to master one’s emotions. In an autobiographical sketch, Graham “embraced stoicism as a gospel sent from heaven.” Among the bulwarks of his “internal equipment” was “a certain aloofness” and “unruffled serenity.” His third wife described him as “humane, but not human.” His eldest son recounted “[Ben’s] mind was elsewhere, and he did have a little difficulty relating to others. He was always internally multi-tasking. Maybe people who go into investing are especially well-suited for it if they have that distance or detachment.” In the final years of his life, Graham remarked that his immersion in classics, literature, maths and philosophy helped him to view developments in economics and finance “from the standpoint of eternity, rather than day-to-day.”

Perhaps as a result, Graham took others’ enthusiasm as grounds for caution and their fear as a sign of hope. His knack for inverting emotions (and of interpreting hard financial statements) helped him to see when people – and the prices they paid – embraced extremes. In 1974, he correctly prophesied a period of “many years” in which “stock prices may languish.” He continued that a long bear market is good news, not bad: “the true investor would be pleased, rather than discouraged, at the prospect of investing his new savings on very satisfactory terms.” He concluded that investors would be “enviously fortunate” to benefit from the “undoubted advantages” of an extended bear market. The bear, in short, is a gift; and the longer it lasts, the better off will be those who have properly prepared themselves for it.

Is This A New Bull Market or a Run-of-the-Mill Bear Market Rally?

Whither the All Ordinaries and other stock market indices? The conviction of the crowd is hardening: the “low” occurred on 9 March, we won’t return to it and anybody who thinks otherwise, never mind his reasoning and evidence (see Leithner Letter 114-116), is a “permabear” who should be either ignored or ridiculed, but certainly not heeded. The contention is that a rise of major market indices by 30% or more within six months is a sufficient condition of the end of a bear market and the start of a new bull market.

But is it necessarily so? Table 8 suggests rather strongly that it is not. The analogy of Daniel Turov (“Mixed Message,” *Barron’s* 21 May 2001), together with financial history, makes much more sense than the relentless cacophony emitted by journalists, “market strategists” and various other babblers. “Bear markets don’t act like a medicine ball rolling down a smooth hill,” said Turov. “Instead, they behave like a basketball bouncing down a rock-strewn mountainside; there’s lots of movement up and sideways before the bottom is reached. During the Great Bear Market from 1929 to 1942, the Dow Industrials had rallies of 48% (from November 13, 1929 to April 17, 1930), 94% (July 8, 1932 to September 7 of that year), 121% (February 27, 1933, to February 5, 1934), 127% (July 26, 1934 to March 10, 1937), 60% (March 31, 1938 to November 12 of that year) and 28% (April 8, 1939 to September 12 of that year). Yet, on April 28, 1942, the DJIA was still at only 92.92, 76% below its September 3, 1929, high of 381.17.”

Turov added “when the bulls stop asking ‘is this the bottom?’ and instead are explaining to their friends why ‘this time it’s different, and the market really is a bottomless pit,’ then it will be time for me to pen ‘Buy Signal, Part 2.’ But we’re a long way from that.” His conclusion applies just as much to Australia as to the U.S. As such, it should – but probably won’t – give the Australian herd pause: “the Dow first reached the 100 level in January 1906. It traded above and below that level for more than 36 years; it wasn’t until May 1942 that the market left 100 behind for the last time. The Industrial Average first reached 1,000 in February 1966. It traded above and below that level for the next 17 years, leaving that figure behind for the last time in February 1983. The Dow first reached the 10,000 level in March 1999. Considering the unprecedented gains of the past several years, would it be that unusual for this benchmark to take a decade or even two before leaving 10,000 in the dust for the last time?”

On 17 September, *The Wall Street Journal* (“The Dow Will Hit 10,000 Soon: So What?”) updated this point, and reminded us about the insidious affects of the CPI’s rise:

The Dow Jones Industrial Average has risen 1,000 points since the middle of July. At 9,783, it’s within hailing distance of 10,000 – a level not seen since last October. What does this mean for you and your portfolio? Not much. It’s ten years and six months since we first passed the 10,000 milestone. Since then we’ve passed it several more times – in both directions. It doesn’t mean the markets are back to where they were: since the Dow first hit 10,000 back in March 1999, the dollar has lost 23% of its purchasing power. So in March 1999 dollars we’re still only back to about Dow 7,500. Thanks to [the effects of the central bank’s] inflation, each “Dow 10,000” is worth less in real terms than the previous one.

A Back-to-the-Future Value Strategy

If they had adhered rigorously to it, would the traditional “value” approach to investment pioneered by Ben Graham have protected Australian investors from the “Global Financial Crisis” that finally erupted in the middle of 2007? Would it have generated reasonable results over the past decade (which also included the “dot com” bust)? The answer, we believe, is “yes.” Most approaches to investment – including those that embrace the phrase “value investing” but repudiate its assumptions and methods – bled profusely during calendar 2008 (the worst year in Australian financial history). Accordingly and unfortunately, few market participants benefitted from the protection that genuine Grahamite value investing could have afforded. One of the ancillary benefits of the recent panic and extended bear market (if that is what we are experiencing), therefore, may be to reacquaint investors worthy of the name with the advantages of paying attention to value.

That would be a fitting 75th anniversary commemoration of what has become the definitive textbook on investing – *Security Analysis*, now in its 6th edition. Given that Graham honed his thinking during the Great Depression, his definition of value was very strict. Rather than define it in relative terms, as do most of today’s so-called “value” managers (“what I’m buying is less overvalued than what you’re buying”), he defined it in absolute terms. That meant that there would be times when the values of few if any securities exceeded their prices. At the depths of the Depression, hundreds of stocks on the NYSE satisfied Graham’s criteria. In subsequent decades that number fell greatly; and by the late 1980s and 1990s there were many occasions in which not even one common stock could satisfy it. An adviser who stayed true to Graham’s criteria, therefore, would – like Leithner & Company during the past decade – have no choice but to accumulate an increasingly large position of cash and bonds.

LCO’s results rebuke those who think that this would have hopelessly handicapped long-term results. So do model portfolios in *Growth Stock Outlook*, a newsletter edited since 1967 by Charles Allmon. Though he has not adhered unerringly to Graham’s principles or definition of value, over the years he has re-

mained truer to Graham than any of the other (ca. 180) newsletters that the *Hulbert Financial Digest* (HFD) monitors and analyses. According to HFD, Allmon's model portfolios have achieved some of the best (since HFD commenced operations in 1979) long-term results of any newsletter. What would Graham be advocating now? Because the number of stocks selling for less than two-thirds of per-share net current assets increased markedly in the first few months of this year, one might think that he would be buying stocks. But according to a *Wall Street Journal* column dated 30 April, Allmon's outlook remains resolutely dour. Like us, he suggests that stocks comprise no more than (and preferably less than) half of investors' portfolios. Expressing little confidence that governments and their crazed interventions will achieve their intended positive results, and even being even less sanguine that they will avoid unintended negative consequences, Allmon concludes "the trick now is to avoid being scalded in a sea of nonsense."

Conclusions

Ben Graham has been long and rightly lauded as the founder of investment analysis. Yet for almost as long, his principles and methods, detailed in *Security Analysis* (1934) and *The Intelligent Investor* (1949), have been ignored. Others' loss is our gain; these principles and methods have served us well. For the past decade, they have enabled Leithner & Company to preserve its shareholders' wealth: LCO has compounded its per-share capital at a rate which has exceeded – and thus compensated for the effects of – the inexorable rise of the Consumer Price Index. LCO has also built its shareholders' wealth: it has invested its capital in a portfolio of securities whose compounded rate of return (whether in "nominal" or "real" terms) has exceeded that offered by 5-year Commonwealth Government bonds.

We've done so at a time of fiscal and monetary chaos. The U.S. Government and the régimes of other major developed nations are, morally as well as financially, bankrupt. The state's inflation – all insiders, regardless of party affiliation, embrace this policy enthusiastically – is both the glue that binds insiders to one another and the poison that impoverishes outsiders. The Fed's (and Bank of England's and RBA's, etc.) present willingness to respond massively to any perceived threat has produced a reckless monetary policy which has and will continue to destabilise economies and financial markets. Alas, fiscal and monetary "stimulus" fixes nothing today; even worse, it bequeaths even bigger problems to the future. Hence we expect that the next decade will resemble the 1970s more than either the 1930s or the 1990s. We anticipate an extended period of stagnation or recession and falling asset prices, together with rising consumer prices and interest rates ("stagflation"). If it reprises the Australian experience of the 1970s, the next decade will also feature sharp bear market rallies (we believe we're in the midst of one now), as numerous as they are ultimately dispiriting, which falter and lead to even lower lows.

The good news is that our very large holding of cash, Grahamite philosophy and expectations about the future dovetail. If we're in the early stages of a long bear market, and if the prices of stocks resume their decrease, we will gradually increase stocks' weighting in LCO's portfolio. We will seek securities that emit a reliable stream of income, and strive to increase the percentage of LCO's income derived from the receipt of dividends. If our assessment of the road ahead is roughly correct, then this shift will stand us in good stead. A rising CPI harms returns by causing capital losses; it does not, by and large, harm the CPI-adjusted value of dividends. A focus upon dividends during such times therefore helps to keep total real returns in positive territory. The more our total return derives from dividends, in other words, the less a rampaging CPI will trash it over time. Further, the greater the dividend as a percentage of one's total investment return, the more stable – and positive – that total return will tend to be over the years.

But what if we are wrong? What if the next decade resembles the 1930s or the 1990s more than the 1970s? Periods like the 1930s, when CPI fell well below zero, were no friend to those who craved capital gains; but they were reasonably kind to returns from dividends. Extended periods when the CPI is "low" (which the mainstream defines as an increase of ca. 2% per year) are most conducive to strong results,

particularly from capital gains. Not surprisingly, the bulls clamour for the reappearance of the “low inflation” 1990s: it would provide an opportunity to recoup some or all of the losses they’ve incurred since 2007. But such an interval is very much the exception rather than the rule. No Western central bank other than Switzerland’s and to some extent Germany’s has ever stabilised consumer prices for an extended period of time. Relatively brief intervals of stability have been followed by extended periods of briskly rising consumer prices. Today’s bulls are unwittingly (and we think erroneously) assuming that the economic and financial “norm” of the Great Bubble was actually normal, and that it will shortly return.

So do politicians and bureaucrats – who, since mid-2007, have attempted to recreate the conditions that prevailed during the Great Bubble. They have injected into Mr Market’s veins a fiscal and monetary shot-in-the-arm no less than seven times stronger – in terms of GDP – than the average post-war countercyclical stimulus. This “upper” (which we suspect is addictive) has opened his eyes, but he still staggers. He’s not so young anymore, and he’s gained weight over the years: he now carries three times the debt-to-GDP as he did in 1982, and stocks are three times as dear, in terms of their average price-to-earnings ratio, as they were then. What’s more, in 1982 he had been following a strict (“deleveraging”) diet for almost a decade; in 2009, he’s barely commenced such a regimen. If we’re wrong and Mr Market returns quickly to health, we’ll do less well than we have hitherto; but if he relapses – that is, the bulls are as wrong in the next decade as they were in the last – they’ll do even worse. As in the past ten years, so too, apparently, in the next: the crowd’s erratic stampedes are considerably riskier than Leithner & Co.’s deliberately slow, unconventional and above all consistent gait. For the crowd’s sake, let’s hope that – unlike the decade just concluded – its results compensate for the risk it’s taking.

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