



Survival of the Longest

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A specter is haunting the world — the specter of gold. Gold is now the only safe and sensible asset, because only gold will survive apocalyptic scenario that is about to unfold. Those who thought “this time will be different” are about to be proven right. Only a few of the most respected authorities of the market predicted elements of the unfolding demise. As, one after another, these predictions come true, we will see the financial markets gradually unravel.

In August of last year I forecast a target of 800 for the S&P, which is about to be tested. This was an easy target to establish, since it represented the low of the 2001-2003 bear market. Last week’s heroic performance – what traders call a “dead cat bounce” - was a temporary respite from the market’s downward spiral. I now doubt 800 will be the bottom for this bear market. There may be more dead cat bounces, but there is no support in sight once 800 is decisively broken. My ultimate target is 400-500 for the S&P (or 4,000-5,000 for the Dow) which will be reached by the end of 2010. The timing of the 2010 bottom is consistent with what was given by Wharton professors Andrew Abel and Jeremy Siegel in 2001 in their “baby boomer cashing out” scenario discussed below.

My pessimism is based on my belief that neither government actions nor unnatural market mechanisms, such as circuit breakers and banning short sales, are capable of arresting this bear market. Many believe this bear market will recover quickly, like it did in 1987. This will not happen. After the one-day 20% drop in the market in 1987, circuit breakers were introduced to limit daily declines. But the market has adapted and selling pressure is distributed over longer time intervals, and the net effect is the same. Regulators could install additional market holidays, like they did in the 1930s, but the market will continue to adapt.

Jeremy Grantham’s Predictions

Earlier this year, Jeremy Grantham of GMO predicted in an interview with Barron’s that the S&P 500 would drop to 1,100 by end of 2010. A lot of people just laughed at him. Was this crazy old man out of his mind? Now, to quote Hamlet, “All the rest is silence.” We always should listen to an old man who experienced the so-called “Nifty Fifty” losing 80% of their market value in 1970s and has extensively studied the Great



Depression of the 1930s. He probably regrets now that his 1,100 target was too conservative.

Jeremy derived his 1,100 prediction with a P/E of 11-12 as a norm for a long-term capital market. With a more representative bear market P/E value of 6-7, the forecast comes out in the 600-700 range. At the extreme of this bear market a few years down the road, the S&P 500 might very well overshoot and drop all the way to 4-500. That was the launch pad for last leg of the bull market that followed the recession of the early 1990s. Everything could go back to square one, while 20 years of bull market returns turn out to be in vain.

How long will this bear market last? Well, the Great Depression caused a bear market lasting over two decades, from 1929 to 1952. Only in 1958 did that market come back to the old 1929 peak, nearly three decades later. The 1970s were not much better—the bear market lasted 14-16 years from 1966 or 1968 to 1982. Even though that bear market ended more quickly, it still took until 1992 — 24 years later — to return to the markets' 1968 peak.

My most optimistic forecast is this bear market will last another 4-5 years, which is overall actually about 12 years if we count 2000 as the starting point. If we use Jim Rogers' commodity super-cycle, which usually runs opposite to the general equity market, this will be the latest two-decade bear market for equities, he predicts, lasting until 2020. When will the S&P 500 be back to last October's peak? No sooner than 2024.

Another reason this bear market differs from 1987 is that, in 1987, the fundamentals were strong, stocks were trending upward, and the market didn't have its economic lifeline of credit severed. There is another fundamental factor now suggesting we face a longer-lasting bear market than the 1970s. It is demographic. Baby boomers are not comfortable with the market turmoil of the past year, and they want to lock in their nest eggs and cash out. Their withdrawals have in turn caused more baby boomers to do the same. They don't want to take the risk of sitting through this credit crisis and bear market, since no one knows how long it will last.

What happens if it lasts as long as two decades? Time is not on boomers' side. How can we blame them? With the real estate market freefalling with no bottom in sight, it is only natural for them to protect their only remaining nest eggs. And they will likely never get back into the stock market again once they cash out, since profiles grow more risk-averse with old age. Their overriding concern is to protect their cash. This is why you see US Treasuries, the so-called safe haven vehicle, with infinitesimally low yields. Boomers will not be tempted by equities even if they reach "undervalued" levels of 50% of book value, 70% of intrinsic value, P/E ratios of 6, etc. Inflation will gradually eat their money away with negative real interest rates, and they will worry about that later when inflation reaches double digits.



The above discussion about baby boomers is not new. In 2001, Abel and Siegel voiced concern about the potential herd behavior of the baby boomer generation — that their cashing out simultaneously could cause a stock market meltdown around 2010.. What an accurate prediction that is. They only missed by two years! Who wants to get caught holding the bag as the last one to cash out at the lowest price in 2010?

Good for Buffett but Bad for Common Shareholders

As the market dives, Warren Buffett's investment in both GE and Goldman Sachs deserve discussion. Perpetual preferred stocks are usually a good way to invest in good businesses, as long as the firms survive, and obviously Buffett thinks both will. I tend to agree. But even if both GE and Goldman survive, such investments come at a large cost to the existing common shareholders.

In GE's case, GE is using Buffett's name and investment to raise \$12 billion in a separate public offering, diluting their common shares. That's not counting on the \$3 billion of GE warrants, which could potentially cause more dilution. Almost all GE industrial units are doing fine since they are usually #1 or #2 in their respective sectors and have some monopoly pricing power. The biggest risk for GE is their GE capital unit, which never reveals the illiquid asset securitization and OTC derivatives in its portfolio, as is also the case with investment banks. And, unfortunately, it accounts for half of GE's earning power. If GE Capital is in the same trouble as Wall Street investment banks, GE will likely have to shut down this division, write down large losses for its portfolio, and they will lose half of their earning power and an important vehicle to smooth their earnings every quarter. But as a conglomerate, they will still survive. The problem is that in an economic depression, with decreasing revenue and a shrinking profit margin, GE's earnings will be depressed substantially. But it will still have to honor its large interest payment to Buffett on the new preferreds before common shareholders see any dividends.

Goldman is a much riskier investment than GE. The largest expense for investment banks is compensation, and they always issue many new shares, on top of cash bonuses, to retain talent every year as part of their incentive program. In an economic depression, there are likely no banking deals, not much trading activity, and especially no more highly profitable structured products like before. Goldman's net income could be running less than \$1 billion in its worst years (like Morgan Stanley is today). But they have to pay Buffett \$500 million — 10% interest on his \$5 billion investment — every year. What is left for common shareholders with Buffett's annual payout and increasingly diluted shares? The incentive program becomes demoralizing. Both deals are really bad for common shareholders.



Bailouts and the Unraveling of Private Equity

There are many angry investors around the country, causing the House to defeat the \$700 billion bail out plan initially. Without Wall St.'s innovations on structured products, the subprime crisis could have been easily contained, even in the face of widespread abusive lending practices. The problem is for every \$1 of subprime mortgages, Wall St. created \$10 CDO products, then the math geeks at structured product groups used those to create another \$100 of OTC derivatives out of thin air (for more on this, refer to my previous article [Why Wall St. Needed Credit Default Swaps?](#)). Now, suddenly, a \$700 billion default of subprime loans would cause a \$7 trillion default in CDOs and \$70 trillion in CDS losses, a crisis 100 times larger than it should be. Now you know why Wall St. is so profitable, because in the past 5-10 years, they have already sucked the blood and "profit" of not only this generation but the next. If Washington is serious about a bailout, its size will need to be measured in tens of trillions instead of trillions.

Not long ago, with a market for CDOs virtually nonexistent, Merrill was forced to sell CDOs at 20 cents on the dollar. That alone sounds bad enough, but Merrill had to finance 15 cents out of the 20 itself, suggesting that those CDOs may really only have been worth 5 cents. In response, banks devalued CDOs in their portfolios, but the markdown was to 20 cents, not 5. The clear implication is that their portfolios are still shored up to more than they are really worth. But any asset writedown has to be matched by equity, and even with the CDOs propped up at 20 cents on the dollar, there is really no more equity to write down for many banks, and no way to raise new equity, leaving liquidation of the firm as the only option. Since debt stays the same, debt-to-equity ratios have to be reduced in the current deleveraging process. As a result, each writedown causes more writedowns, and it becomes a death spiral and a "no way out" situation.

In the summer of 2007, Jeremy Grantham predicted half of hedge funds will get wiped out, and more than half of all private equity firms will vanish. Let us just look at the private equity sector, which, in boom years, can achieve a 50% return easily.

Let us look at a hypothetical deal: PE Firm A, with a 2+20 fee structure, purchased Company B for \$4 billion. It did so by borrowing \$2 billion at 6% interest, netting \$1 billion in 2 years by IPO — a very typical deal in the good old days. It yields a 50% return (\$1 billion on a \$2 billion investment) for the PE firm. But for you as a PE investor, your share of that return is: \$1B profit - \$0.08B fee ($2\% \times \$2B \times 2 \text{ yr}$) - \$0.2B PE profit cut - \$0.24B interest ($\$2B \times 6\% \times 2 \text{ yr}$) = \$0.48B, or 24% return ($\$0.48B / \$2B$). The same deal that seems to achieve a 50% return (for the firm) has a real return for its clients that is only half that.

Now let us use the same example above, but let us say the equity market enters a couple of years of bear market like we are facing now. The same deal now takes 5



years instead of 2 years to spin off in an IPO. What would the return for PE clients be?

The answer is *zero*. It is: \$1B profit - \$0.2B fee ($2\% \times \$2B \times 5 \text{ yr}$) - \$0.2B PE profit cut - \$0.6B interest ($\$2B \times 6\% \times 5 \text{ yr}$) = zero. Five years for nothing. The extra 3 years of interest payments and the excessive 2+20 fee structure eat all of the remaining profit. For all corporate pension funds, state and local government retirement funds, endowment funds and foundations rushing to invest 10-20% of their resources in private equities: Do they realize investing in 5%-per-year US treasury bonds (27% over 5 years compounding) would actually offer better return and carry no risk at all (except the risk of holding the US dollar)?

In the above calculation, I didn't even factor in a long recession with a decade long bear market, the reduced revenues and deteriorating profit margins that would result, or potentially large losses for businesses the PE firm may have purchased. This is why Jeremy was so confident about his prediction, even though he was still in the middle of the bull market last year — predicting only half of them dead was conservative. Now, with the clock ticking, no credit for financing, and no equity market for IPOs to cash out and dump the risk to the public, it's likely that the whole private equity sector will get wiped out by the end of 2010, just like the investment bank sector.

Diminished Returns Across US Industries

For a decade-long recession and likely depression, the only firms that will survive are those preserving cash by cutting their workforce; stopping capital expenditures, R&D and IT investments; cutting dividends, including preferred dividends; and discontinuing stock buybacks. Things will get very nasty. Only firms that can still manage to generate net cashflow during a depression will emerge as survivors, as in 1930s and 1970s. Newer companies with experimental technologies will be vulnerable and regarded as nonessential, and undercapitalized private firms will be in trouble since the IPO window will be shut for the unforeseeable future. Venture capital firms will have to hold on to their investments forever, at least another decade, without any IPOs in sight, until all their cash is burnt out. Many firms relying on bank financing will not survive. The only businesses that will thrive will be cashflow-positive energy firms and mining producers.

Pretty soon, people will realize holding cash in US dollars is also unwise, due to its quick deterioration. The current rise in the US dollar is due to short-term disappearance of the money supply, since banks don't want to lend money. Once the government socializes the banking industry and floods the system with worthless paper, people will downgrade US Treasuries, since the US government is buying and holding the worst quality mortgages and CDOs dumped by the banks.



In a normal bankruptcy process for investment banks, common stocks, preferreds and subordinated debts get wiped out. Bondholders act as a cushion and suffer some losses, but usually customers and trade partners are protected. The current bailout plan, the previous Bear Stearns bailout, and the AIG bailout all use taxpayer money to bail out the bondholders and the preferreds, which are held mostly by institutions. The bailouts basically wipe out individual investors, then use taxpayers' money to protect large institutions.

The next thing that will happen is all investors, including foreign central banks, will dump US treasuries and buy the ultimate asset everyone around the world trusts — gold. People will realize this is worse than the 1930s — at least then fiat money was backed by gold. Now the US dollar is backed by the \$10 trillion national debt and the larger unfunded obligations of Medicare, Medicaid, Social Security, pensions, and the GSEs. Failures in the banking, auto, and airline industries loom on the horizon. Government can't socialize only the money losing sectors, and taxpayers and lawmakers have only so much patience. They can't tolerate this forever. Pretty soon, the government will need to take over a profitable sector, like energy firms, to offset some of its losses. The US is moving down the slippery path of socialism quickly.

There will be a nuclear winter for many years to come. It's no wonder that many years ago George Soros correctly predicted that there would be the end of globalization and the death of capitalism. This is the payback time for all the abuses select elites have committed against our whole society, but now that it's here, the public is footing their bills. If the G-7 is serious about bailing out the global economy, the only way to do it is to have double-digit hyperinflation to inflate the whole world out of depression at any cost. And they have to do it now. It can't be half-hearted either; otherwise it will end up being the worst nightmare of hyperinflation coupled with an immense depression. This means all commodities will skyrocket and currently slumping commodities would provide the best buying opportunity before oil goes to \$150 and gold to \$2,000. When people lose faith in fiat money, the next thing to happen is barter like in the Weimar Republic, where only commodities, especially gold, are treated as money.

This is the end of an era, one characterized by financial engineering and alchemy, capital manipulation and distortion, the flooding of fiat currencies, and the deluge of paper assets like stocks and bonds. It is the beginning of a new, honest and real money era: the gold era

In this difficult period, do nothing and hold nothing but gold. Only gold, the ultimate asset that has survived the longest in human history, can save us now.



**A 15 year market veteran, Thomas Tan employs a combination of fundamental and technical analysis in searching for the most promising sectors in the market then investing via diversification. As a former Investment Director at VesTopia, you can view his profile and old blogs at www.vestopia.com/thomast, and his own blog at <http://tzt-investment.blogspot.com/>. He can be reached at thomast2@optonline.net.*

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