Greg Feirman

From: Greg Feirman [gfeirman@topgunfp.com]
Sent: Sunday, December 14, 2008 12:58 PM
To: gfeirman@topgunfp.com
Subject: Top Gun FP Client Note: The Causes Of The Financial Crisis

> Behind the debates over future policy is a debate over history – a debate over the causes of our current situation. The battle for the past will determine the battle for the present. So it's crucial to get the history right.
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> - Joseph Stiglitz, "Capitalist Fools" (http://www.vanityfair.com/magazine/2009/01/stiglitz200901), Vanity Fair, January 2009
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> The truth is most of the individual mistakes boil down to just one: a belief that markets are self-adjusting and that the role of government should be minimal. Looking back at that belief during hearings this fall on Capitol Hill, Alan Greenspan said out loud, "I have found a flaw." Congressman Henry Waxman pushed him, responding, "In other words, you found that your view of the world, your ideology, was not right; it was not working." "Absolutely, precisely," Greenspan said. The embrace by America—and much of the rest of the world—of this flawed economic philosophy made it inevitable that we would eventually arrive at the place we are today.
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> - Joseph Stiglitz, "Capitalist Fools" (http://www.vanityfair.com/magazine/2009/01/stiglitz200901), Vanity Fair, January 2009
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> Absent from such conclusions is the central role the government played in creating the crisis. Yes, many Wall Street leaders were irresponsible, and they should pay. But they were playing the distorted hand dealt them by government policies. Our leaders irrationally promoted home-buying, discouraged savings, and recklessly encouraged borrowing and lending, which together undermined our markets.
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> - Peter Schiff, "Don't Blame Capitalism" (http://www.washingtonpost.com/wp-dyn/content/article/2008/10/15/AR2008101503166.html), The Washington Post, October 16, 2008
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> The actual causes of our financial troubles were unusual monetary policy moves and novel federal regulatory interventions. These poorly chosen policies distorted interest rates and asset prices, diverted loanable funds into the wrong investments, and twisted normally robust financial institutions into unsustainable positions.
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> - Lawrence White, "How Did We Get Into This Financial Mess?" (http://www.cato.org/pub_display.php?pub_id=9788), The Cato Institute, Briefing Paper #110, November 18, 2008
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> The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist.
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> - John Maynard Keynes

One of the most important determinants of our economic recovery and the future of the American economy in the years ahead will be government policy. As we wind down trading for the year and in anticipation of the inauguration of our new President-elect in January, this strikes me as a good time to step back and think about some bigger picture issues.

Everyday, it seems, the Fed or the Treasury announces a new government bailout. A loan for AIG, a backstop for Citi, $700 billion for financial institutions, money for the automakers, etc… Last weekend, President-elect Obama announced a huge stimulus plan focusing on the nation's infrastructure. Many are calling for a New New Deal and the President-elect said he has been reading about FDR's first 100 days in office. Commentators are proclaiming J.M. Keynes the economist of the moment.

Behind much of this policy and rhetoric is the assumption that the free market is to blame for our current financial crisis. Wall Street greed and lax supervision by Washington allowed a massive bubble to inflate, harming ordinary citizens and damaging the entire American economy. The repeal of Glass-Steagall, Greenspan's laissez-faire financial oversight, the Bush tax cuts - all made possible a capitalist version of the Wild West that was ultimately unsustainable and unstable.

On the other hand, free market theorists lay the blame squarely on the shoulders of government. In his Cato Briefing Paper, Economist Lawrence White highlights loose monetary policy by Greenspan following the tech bust and the enormous expansion of Fannie Mae and Freddie Mac, the government backed mortgage purchasers and securitizers.

The two best overviews on either side of the debate that I've come across are:

Joseph Stiglitz, "Capitalist Fools" (http://www.vanityfair.com/magazine/2009/01/stiglitz200901?currentPage=1), Vanity Fair, January 2009

Lawrence White, "How Did We Get Into This Financial Mess?" (http://www.cato.org/pub_display.php?pub_id=9788), The Cato Institute, Briefing Paper #110, November 18, 2008

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Regardless of which side you stand on, or which side is true, it seems likely that the free market will take most of the rap. This is what the rest of the world, including Europe, China, Russia and the Middle East, want to believe and it feels to me like the intellectual tide in the West is shifting in this direction.

As investors, this becomes a significant factor we must consider:

- What does it mean to invest in banks in which the government owns a significant stake through preferred shares? Will the government, then, have some say over the way they conduct business?

- What does it mean to invest in an economy in which the government is picking winners and losers? Does it mean a company like Citi, with Robert Rubin serving on its board, is more likely to get government aid than a company like Bear Stearns that refused to participate in the government coordinated bailout of Long Term Capital Management in 1998?

- What does it mean when the US government runs annual defecits approaching a trillion dollars? How are we going to pay for all this excess spending over tax revenues?

- What does it mean when the US Federal Reserve expands its balance sheet by trillions of dollars in a matter of months and keeps the Fed Funds rate at 1% for a prolonged period of time? What are the ultimate consequences of all this easy money?

I certainly don't have all the answers. But as government intervention in the economy increases, that intervention becomes a bigger and bigger factor in determining economic outcomes. ***This is becoming an even more important part of the economic landscape and it's something investors need to consider when making decisions.***

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Perhaps the biggest, certainly the most disturbing, story on Wall Street last week was the scandal involving Bernie Madoff. Madoff Investment Securities has been around since the 1960s and is a significant market maker in NYSE and NASDAQ listed securities. So it was a surprise to many when Madoff's investment advisory business was revealed to be a massive Ponzi Scheme with losses said to be $50 billion by Madoff himself. Madoff was the toast of many of his investors who had come to appreciate his incredibly consistent returns – only three down months between January 1996 and December 2004 – and the subject of skepticism by many who couldn't understand how he could do this. Turns out the skeptics were right. He kept up appearances by paying old investors not with money earned through investments but with money from new investors. When investors asked for $7 billion in redemptions amid the current financial collapse, Madoff couldn't meet the obligations and his scheme collapsed.

From the perspective of individual investors using investment advisors, the most important issue here is ***the distinction between discretion and custody***. Top Gun, for example, has discretion to manage client funds but not custody. That is, I never take possession of any client money. Clients set up their own individual accounts with Scottrade and sign a form authorizing me to trade for their accounts. Each individual account links to my master account from which I can trade it. But I never have possession of the money. I don't keep the records. Scottrade takes care of all that. This is great because clients don't have to worry about me sending the money to my offshore account in the Bahamas or about me fudging the records. Scottrade has the money, they keep the records and clients can log in to their own personal accounts 24 hours a day, 7 days a week. It's also great for me because it frees me from all the back office work and record keeping, allowing me to focus on what I do best: analyzing the markets and making investment decisions.

In the case of Madoff Securities, Bernie Madoff controlled everything. He made the investment decisions and he also had custody of the funds and kept the records. There was no intermediary to keep a watch on what he was doing. Everything was based on trust. Trust we now know was not warranted.

There are set ups in which custody of funds makes sense for an investment advisor and his clients. ***But whenever an investment advisor seeks to take custody of your funds, it is very important that you do a high level of due diligence***. There are scores of stories of investment advisors making off with client funds. You should always ask a lot of questions and do some thorough research before you hand over your money to anybody. You should find out about the custody, transparency, access and record keeping concerning your investments. No decent investment advisor should take offence at your questions because many have lost all their money by not asking questions.

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Here's how the week went:

S&P: +0.42%

Wilshire: +0.72%

Top Gun: +8.60%

And Y-T-D:

S&P: -40.09%

Wilshire: -40.62%

Top Gun: +9.39%

Greg Feirman
Founder & CEO
Top Gun Financial Planning (www.topgunfp.com)
A Registered Investment Advisor
9700 Village Center Drive, Suite H, Granite Bay CA 95746
(916) 224-0113