

# **C** *Economic & Market* Commentary

## **Integrity, Confidence and Trust**

People in positions of power often claim to have integrity, and the public needs to have confidence in those people in order to trust the system. The sheer number of “ethically challenged” individuals that have surfaced lately makes it increasingly difficult to see through this haze of hypocrisy and to trust anything. At present, there is a crisis in confidence so great that many investors are willing to accept a zero return just to have the U.S. Government hold their funds.

If you take a quick glance around the country, you’ll find a Governor who attempted to sell a Senate seat, a self-anointed savior of the masses (also a Governor) patronizing a prostitution ring, a Senator convicted of several felonies almost winning an election, and numerous other government officials taking liberties, receiving special treatment or deals. Those in professional sports also continue to be ethically challenged, from athletes doping to referees influencing games for personal benefit. Hollywood and the music industry provide enough content year-in and year-out to keep thousands of magazines, newspapers, and web sites in business. Remarkably, we allow this type of behavior to continue by giving candidates our votes and contributions, and by buying tickets, magazines and memorabilia. Integrity has been all but lost in political maneuvering, convenient omissions, and downright deceit.

I left the financial industry out of the previous paragraph only because its problems have been so plentiful it needed its own paragraph! Bigger, better, more complex has been the cry from Wall Street for the last decade and that has produced overpaid, ethically challenged executives, programs and products like hedge funds and sub-prime loans, and fund-of-funds and credit default swaps. The list goes on and on. As things became more complex, investors found themselves further removed from their money and the people actually responsible for its well being. Although stockholders have always had the ability to vote on the tenure and compensation of a company’s management, most investors are not in a position to do so in a meaningful way. When twice removed from the actual investment, as is the case when investing in a manager of managers program or mutual funds, investors must rely on highly-paid executives to vote on the tenure and high salary of other executives, in a more or less self-perpetuating cycle. Exerting shareholder control has become a thing of the past for most individual investors.

As Warren Buffet said, "It's only when the tide goes out that you learn who's been swimming naked." Growth hides many structural problems and 2008 was a year of revelations. Take the case of hard-money lenders. In many parts of the country these firms were lending money directly to developers and builders and offering steady 12 percent returns to investors. A few years ago, Stellar interviewed two such local firms and, after substantial due diligence, decided to wait out the brewing storm. In general, we saw that these programs were becoming less sustainable due to the lack of appreciation and new buyer interest in development projects. One firm, now in the headlines, lacked enough internal controls for our comfort and we eliminated them from consideration. I’m sure other firms like ours made similar decisions;

but some did not. More recently, Bernie Madoff's complex "Ponzi" scheme made the headlines, leaving a mess for investors and regulators. In both cases, integrity was lacking and trust was betrayed. Other firms misrepresented the scope of their services, appearing to be sophisticated money managers on the outside, but when the tide went out, were found to be nothing more than high-priced marketers or "feeders" for the real manager of the assets, offering no real value to their clients.

To recover from the present economic ills, massive stimulus programs are being worked into the system. This has effectively put a safety net under the economy in an effort to restore confidence. As confidence replaces fear, a valid case can be made for either: a "¾ V-shaped" recovery, where the economy recovers into a less leveraged, slower growth version of itself; or a "W-shaped" recovery with a double-dip recession beginning near the end of 2010. Due to decreased leverage in the global economic system, a more typical "V-shaped", or complete, recovery does not seem likely in this cycle.

Barring more surprises, the economy should transition from stimulus-driven economic activity to organically-driven growth in late 2009, leading to a ¾ V-recovery. As we approach 2011, the prospects of higher tax rates due to "sunset" provisions in the current tax code could cause economic activity to accelerate. This would create an after-the-fact lull in economic activity, pushing it back to recessionary levels in 2011, leading to more of a W-shaped recovery. The eventual shape of the recovery depends on how and how much stimulus is deployed, the extent and timing of its removal, and other policies established to smooth the transition both here and abroad.

At some point, the investment markets will turn around. Since mid-November, the S&P 500 has risen about 20 percent, rebounding from "technical support", and building a potential "bottom" around the 900 level. Volatility has calmed down a bit, and liquidity seems to be coming back into the markets. However, that has not stopped the yield on 10-year U.S. Treasury bonds from falling to levels not seen since 1955, and coming close to the lows experienced during World War II. The economy is still trying to find a stable footing, and economic data in the next few months will probably continue to be ugly, but the markets may have already discounted the expected data and may be beginning to look beyond the present abyss.

While we believe that world affairs are in better shape than they were during World War II, the bigger issue facing capitalistic societies today is "trust." Without it, the economy will stumble; with it, it will thrive. When trust comes back to the system, investors will be less willing to park money in essentially non-interest bearing Treasury bonds, and more interested in making educated, longer-term investments.

Here's to trust...Happy New Year!

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