

## **EXECUTIVE SUMMARY**

### **Introduction**

The keynote theme for the 2006 MCM annual report is found embedded in a quote from Charlie Munger on page 15. To paraphrase, Munger advises that one should continuously search and wait for conspicuous, logical, and simple investment opportunities that will be recognizable as such. They will be few and far between, but if one bets heavily when the odds are highly favorable, “using resources available as a result of prudence and patience in the past,” one’s lifetime investment results will be improved dramatically. As productive as this seemingly slow-motion, yet cerebrally active, style has been, it remains almost unknown, largely because most people make little effort to cultivate their intellectual independence, instead taking the path of least resistance in following the conformist crowd.

Moreover, misaligned incentive systems for the sellers of intangible services often put them in direct conflict with the interests of their customers or clients. “Incentive-caused bias” frequently leads to unethical or even illegal activity on the part of the sellers who rationalize their aberrant behavior through a self-delusional psychological process to avoid “cognitive dissonance.” The record-breaking \$36 billion in “carrots” (which could buy a lot of karats) paid to the employees of the five largest investment houses in 2006 should give an investor pause regarding the ends to which the sales personnel, traders, and investment bankers might go for such a king’s ransom.

Additionally, the physical separation of ownership (the principals) and management (their agents) in most American corporations has understandably given rise to reduced accountability and increasingly egregious abuses by the agents of their often unchecked powers. Stock-option abuses, obscene compensation packages, and the usurpation of power are among the crimes and misdemeanors. Emmis Communications Corp. is cited as an example.

### **Investment Performance**

While MCM’s average compounded annual 10-year equity investment performance of 12.4%, after fees, exceeded the Standard & Poor’s 500 by a full 400 basis points, of more immediate interest is that we trailed the S&P for the last three years, 10.4% vs. 3.1%. The underperformance is attributable primarily to “thumb sucking” when we should’ve been acting on three anemic holdings. And for some accounts the drag of expenses associated with hedging the risk of catastrophic loss negatively impacted overall portfolio results. There is nothing we can do about reducing the cost of insuring selected equity portfolios, since the premiums we are paying are the lowest in years. However, the relative underperformance of our equities compared with the benchmark has been a call to arms. While our investment management process is still highly efficient, we always strive for perfection. After demonstrating the strength of our independent convictions and capacity to find Main Street bargains in the savaging, technology-driven, two-year bear market, 2000–02, when our equities appreciated 59% while the S&P 500 fell

20% and the Nasdaq plunged an astounding 80%, we may have become victims of our own success. To be sure, that was yesterday. In this profession any significant pause to rest on one's laurels can soon lead to the startling realization that laurels can be downright prickly to the posterior! While we expect you'll presently see the positive effects of the rigorous examination of our less than masterful misjudgments, perhaps of more immediate import is that we have embarked (reminiscent of 1999) on an investment strategy so uncommon that few investment managers are thinking about it, let alone taking action. Our "contrarian" strategy stems in part from our comparatively unique role as a "wealth manager" for individuals, whereas most of our peers are specialized, one-dimensional horses in a stable of managers. Our mandate is to keep our clients wealthy in absolute terms; the mandate of our peers is to beat their designated benchmark index, meaning they would consider it a good year if they were down 20% and the index were down 25%. Imagine how good you would feel after two consecutive years of such "positive" relative performance ... Enough of such "positive" negative relative returns and you end up in the soup lines! Feeling much as I did in 1998-99, although for entirely different reasons as explained throughout the report, we are preparing for an opportunity set somewhere in the ideally not-too-distant future that will be far more appealing than the dearth of rationally priced opportunities we're seeing today. [Yes, this report is once again written in the first-person singular by MCM's senior partner with the concurrence of the managing partner and other partners.] After reaching 70% of our assets in December 2004, capital committed to equities has declined to less than 33% recently. In addition, we have attempted to partially hedge the equities that remain through the use of long-dated LEAPS (Long-term Equity Anticipation Security) options. We believe that we do understand what it takes to earn above-average, long-term returns and why the vast majority of advisors fail to do so. You may wish to reread the first paragraph in this Executive Summary.

### **The Equity Risk Premium: Passé?**

*"This is the reason that history has not dealt kindly with the aftermath of protracted periods of low-risk premiums,"* Alan Greenspan warned repeatedly. This eight-page section of the report defines equity risk premiums and provides copious evidence that they are, and have been, at dangerously low levels across the board. While we certainly cannot pinpoint when, we are confident enough to act aggressively in preparing to capitalize on the agonizing for some, opportunistic for others, "aftermath of protracted periods of low-risk premiums." One of the surest ways for an investor to avoid serious losses—or to capitalize on "shooting fish in a barrel" opportunities—is to have a clear understanding of the degree to which investors are at any given time willing to embrace risk in the pursuit of gain. When investors show reckless disregard for the consequences of risky ventures, run for the hills. When they're terrified of "risky" investments, misperceived as a result of the losses they have suffered, jump in with both feet. This essay is a must-read for the investor who isn't interested in the details but is looking for a simple and powerful truism (or two) on which to hang one's hat.

### **Rationality**

Rationality, according to Warren Buffett, is the most important single word in the investor's lexicon. Its frequent absence goes a long way in explaining why

smart people do dumb things. Despite the importance of rationality and its inverse corollary, irrationality, most investors aren't particularly well aware of the forces behind irrational behavior that often lead to ruinous results. Accordingly, we devote 15 pages to the subject. We begin by turning to Machiavelli and others to build a case for the practical relevance of the asymmetrical but nonetheless recurring cycles of financial history. For of what good is rationality if history is nothing more than a series of random events? Underlying the importance of rationality has been the relatively recent reintroduction of behavioral psychology to explain why economies and investors act in ways that often do not appear rational. Interestingly, classical economics, its origins dating back to the late 1700s and Adam Smith's *The Wealth of Nations*, acknowledges the importance of the moral sentiments of the manufacturers and the merchandisers. Neoclassical theory is far more quantitative, thanks to 20<sup>th</sup>- and 21<sup>st</sup>-century advances in data-processing technology. Despite the renaissance of classical economics (behavioral economics as it is now called), many venues, particularly academia, preach modern portfolio theory (MPT) dogma, which has as one of its basic (twofold) tenets that investors are rational beings and the markets are, therefore, efficient.

We believe that the impediments to rationality are a host of biases, both conscious and subconscious, as well as the emotions of envy and fear, which we define and discuss at length. Presently, envy is in full bloom. Fear, the provocateur of the most irrational of behaviors, has been dormant but could arise from its slumbers virtually overnight.

From there we move to the way we assimilate information and ideas—and the respective roles that the left and right hemispheres of the brain play in different thought processes. Right-brainers process information holistically unlike left-brainers, who are more logical and sequential. In the world of investments we reap in an always uncertain tomorrow what we sow today. How we envision the future is greatly influenced by how we process information. Intuition, predominantly a right-brain attribute, is gaining more credence for its application under conditions where the outcomes are uncertain. Several prominent authors have sought to integrate intuition with reason to achieve optimal rational outcomes, particularly in solving complex multidisciplinary problems. This is quite a stretch for the mechanistic thinkers who have difficulty connecting the left- and right-brain characteristics.

### **The Perfect Storm Redux**

On the heels of last year's Perfect Storm? essay, we revisit the subject with a vengeance this year. After 36 pages of discourse, it should be clear that we still don't take this threat lightly. We begin by flashing back, with the help of three world-famous intellectuals and practitioners, who are also friends, to the equity risk premium nemesis, which reminds investors of the importance of focusing on risk before they think about return. We then review what we thought possible a year ago and what actually came to pass, particularly with regard to the housing Bubble.

This year we introduce economist Hyman Minsky, the profession's watered-down equivalent of Sir Isaac Newton, and his revolutionary ideas about the interconnectedness of the financial and economic systems—and the notion that they are in a constant state of flux. These are the same ideas proposed by Marc Faber in his "financial" vs. "real" economy exposition about which we've written

over the last several years. Minsky's cause-and-effect perspective is as intriguing as it is provocative, particularly his analysis of the Great Depression, which is, in this writer's opinion, more plausible than that of John Kenneth Galbraith in his popular book *The Great Depression*. More than 12 pages are dedicated to the work of friend Doug Noland and his scholarly dissertation on the escalating disarray in the worldwide financial system. His well-articulated concerns about the global credit glut, banking, the dollar, and derivatives, among other threats to stability, should not be swept under the carpet. Warren Buffett is quoted from the nine-month-old Berkshire Hathaway 2005 annual report on the threat that derivatives pose to both the financial system and the economy. After pointing out the awful fix in which Federal Reserve Chairman Ben Bernanke presently finds himself, we wrap up the essay by updating two ratios to which we referred in the last two annual reports: the total market cap to gross domestic product and the total debt-to-GDP ratios. These ratios serve as simple approximations of where we think we are in the grand secular (which, in economic parlance, refers to long-term rather than non-religious) cycles. The total market-cap-to-GDP ratio is approximately 145%, compared to a 70-year historical range (ending in 1995) of 30–80%, with an average of 60%. Since 1995 the ratio has gone through the roof. Likewise, the total debt-to-GDP ratio, after hitting 270% in the depths of the Depression, repented for nearly 50 years in the range of 120% to 140%. Memories of the great travails having faded, along with a new crop of risk-hungry speculators for whom the study of financial history is not germane to the pursuit of (for lack of a more discreet word) money and all that it represents, coupled with a gradual decline in interest rates from the early 1980s, resulted in this leverage ratio hitting a record 330% of GDP in 2006. This may be heralded as a new era, but then the lessons from the ages teach us unequivocally that there are no new eras in finance, only new iterations of old errors.

Before you become too sanguine about the way things are and overconfident about any assumptions you may entertain as to why they will always be this way, carefully read the following from George Eliot's tragic story *Silas Marner*.

The sense of security more frequently springs from habit than from conviction, and for this reason it often subsists [endures] after such a change in the conditions as might have been expected to suggest alarm. The lapse of time during which a given event has not happened is, in this logic of habit, constantly alleged as a reason why the event should never happen, even when the lapse of time is precisely the added condition which makes the event imminent.

### **A Tale of Two Americas Rethought**

In this 20-page section we attempt to determine where the finger of blame might be pointed during a time, at some unspecified point in the future, of great economic distress—an eventuality we deem possible but have no idea as to its probability. The scapegoat will not, we believe, be those who occupy the top-income quintile in the U.S. Census Bureau's study of income differentials in this country. It is not the overstated inequity between the top and bottom income quintiles, to which we attend in detail, that will draw the wrath of the masses.

Rather, it is the super-rich, the titans of Wall Street and the corporate chieftains with compensation packages 400 times greater than those of the workers on the factory floor at whom public anger will be coalesced and directed. If you think the social safety nets rigged in the 1930s will protect the public from the reckless shenanigans of those in high places, this essay is a must-read. It closes with excerpts from a speech given more than 75 years ago in a time of overwhelming national crisis. It is not outside the realm of possibility that words such as these could well be heard again in the not-too-distant future.