TOCQUEVILLE

Year in Review: A Note from Robert Kleinschmidt

BY ROBERT KLEINSCHMIDT ON *DECEMBER 5, 2013*

The year drawing to a close has been a remarkable one, and not just because of the stellar performance put in by the market. Economic, and, more strikingly, political, developments which one might have thought would have had profound negative influence on the market seemed not to have mattered to equity investors. At the same time, the market's bull run seemed to have an equally unimpressive impact on the investing public, as fund flows, or more accurately, lack thereof, into equities demonstrated. What, exactly, is going on?

Fortunately, portfolio managers do not have to answer such questions. Their role, and particularly, as I see mine, is to purchase shares of good companies at bargain prices when they have fallen out of favor with the investing public, and hold them for as long as their prospects appear under appreciated by the markets. Though hardly a walk in the park, this is far easier to accomplish than to predict with any accuracy, and more importantly, with any consistency, the path of the overall market.
That said, we did predict, last year, a benign market environment. Our reasoning then was that the "fiscal cliff" would be the 21st Century equivalent of Y2K: To wit, much ado about nothing. Ditto, it turns out, for the sequester, and now, as recent data has shown, "la meme chose" for the government shutdown. These political hysterics may sell newspapers and win or lose votes, but they have had little effect, correctly, in my view, on the markets. Why? Well, in part, because, notwithstanding all the dire rhetoric that surrounded them, the numbers involved were tiny, on a relative basis, compared with the overall burden of public sector spending or when compared with the economy as a whole. The markets, it seemed, saw through the rhetoric and concluded, rightly, that the emperor wasn't wearing any clothes.

This is not to say that there are not very large fiscal issues that must be addressed. The entire entitlement structure of the Federal government must be overhauled. At the state and local levels, public employees' pension issues are overhanging most budgets. But these problems are far from unknown and the solutions to these issues are both simple and obvious, in spite of the political difficulty involved in getting to them. And, so, the markets seem to have concluded, they will be solved. I concur, but not without some drama and pain.

Beyond looking past political shenanigans, the markets also seemed indifferent to anemic economic growth in the U.S. and elsewhere. Now, markets are supposed to be discounting mechanisms and what they are supposed to discount is the future. They may be wrong about the future, in which case they must adjust and discount a new consensus future, but in no event are the markets expected to discount the present or the past. Consequently, one could conclude that the markets have discounted a brighter economic picture than the sluggish growth one which is currently in focus. If so, there is room for disappointment in the year ahead, and caution is warranted. True enough, but from our risk averse, capital preservation orientation, caution is always warranted. So I can't say much is new there.

That the investing public at large has not been lured back into the markets in droves after such an impressive uplift is by far the most interesting and telling development of the past year. What it signals to this long-time observer, is a sea change in public attitude regarding equities, coupled with a secular shift in demographics. While both factors are important, it is the latter, I suspect, which is the more profound and the longest lasting. First the former. After the collapse of the internet bubble in 2000 through 2002, and followed so closely by 2007 through 2009 meltdown, the bloom seems to have come off the rose of the equity markets for many erstwhile investors. Much like the wariness of generations after the 1929 collapse and the ensuing Depression, generations of investors who were raised on the notion that there was no alternative to equities have been badly burned by the markets and are in no hurry to reengage. Risk taking has lost its allure to

many, and just as deleveraging is the strategy of choice for debtors, fixed income securities, as witnessed by the huge inflows into bond funds over the past few years, have become the investment vehicle of choice for many. That this has turned out to be precisely the wrong strategy is of no particular moment, and I suspect that it will take far more ebullience in the markets even than what we have seen this year to change that mindset.

As for the demographic shift, this is increasingly well documented, though, astonishingly, few were speaking of it only a few years ago. The implication for the markets, as well as for public policy and the national fisc, are profound. An aging population is a dissaving population, and the long standing zero interest rate policy of the central bank implies that retirees cannot count on their savings to provide them an income. This means, perforce, the need to "eat" their capital, and/or to continue working. But in either event, it does not mean reengaging with an equity market perceived as risky. So, for the foreseeable future, one should expect to see considerable flow out of the equity markets from this large group, as baby boomers cash in their IRAs, 401(k)s and other savings to pay for their living expenses.
Nor is this the only demographic change of note. The ethnic and cultural make-up of the nation is changing rapidly and it is not too much to speculate that the new America will have different attitudes about risk and entrepreneurship than the one it replaces. It certainly seems that the role that government is expected to play by the emerging majority will be different and larger than what was acceptable in the past. Whatever positive societal alterations may occur as a result of these changes, these developments are likely to have the same long term effects on equity markets that they have had in many other countries where these attitudes, expectations and policies prevail, i.e., not exactly salutary.

But there is little that an investor can do about these large changes, other than to be cognizant of them, so, I return to my earlier premise that portfolio managers should stick to their knitting and concentrate on finding and owning shares of good companies, at reasonable prices, and let the equity markets take care of themselves. It is an approach that worked well this year and has generated consistently satisfactory returns—at least from the perspective of our loyal clients. It is also the approach we will continue to employ, with caution, in the years ahead.
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