ACR alpine capital research

Sovereign Tremors and Real Wealth

The volatility we had hoped to leave behind last year reared its ugly head this week. Stock market returns in 2010 were knocked back to break even. ACR / Alpine equity accounts have fared a little better.

The specter of sovereign failure has replaced that of financial institution collapse. We do not know how the circumstances in Greece and the rest of Europe will unfold, but we are prepared either way.

ACR equity accounts are again positioned defensively. We have taken profits in recent months as certain stocks have reached full value, and we are investing newer accounts only as opportunities present themselves. Moreover, our income oriented clients have a fortress of high grade fixed income assets able to weather the very worst of storms.

While our portfolios are positioned defensively for valuation reasons, we remain optimistic about the long run viability of the world economy. To understand why, consider the nature of real wealth.

Economic wealth consists of things like factories, machinery, workers, software, computers, entrepreneurs, know-how, houses, and cars. Whether our currency is dollars, Euros, or sharks teeth, we have been steadily making more and better things with less labor for the past couple of hundred years. The free enterprise engine which created our prosperity is alive and well.

Now consider that financial assets like stocks and bonds are not in themselves wealth. Their value resides solely in the fact that they represent claims on the aforementioned real things. When Lehman bonds failed, or if Greek bonds fail, buildings and Greeks do not disappear. The buildings get new owners. The Greeks still wake up the next morning (though I would prefer a few stay in bed). Assets changing hands in bankruptcy or bailouts are wealth transfers, not losses.

The key from our perspective is to avoid being in the group unwittingly transferring their wealth by making bad investments. Our job is to make sure that does not happen. The solution is to only own quality assets with low debt ratios at the right price.

Financial crises, of course, produce real losses in addition to such transfers of wealth. These losses consist mainly of lower incomes, unemployed workers, and idle capacity. While painful, incomes eventually rise again and unemployed workers and idle capacity eventually get absorbed.

The larger concern is that an epic crisis will cause a systemic full stop. It nearly happened last year. I remain somewhat confident this will not happen because the consequences are too severe. If necessary, the powers that be are likely to reach this conclusion again and act accordingly.

Now let us say the system comes to a full stop. History has shown that after things stop, they start again. In this case, there is more turmoil, higher unemployment, and even the possibility of sovereign failure.

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Nevertheless, free enterprise economic systems at some point return to their long-term productive capacity, and the productive capacity of the US and world economy remains as prodigious as ever.

We hope to never witness a full stop. At the same time, we do not mind a little correction so we can put our ample cash reserves to work.

Nick Tompras
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