Steve Jobs Didn't Give a *!@% About the Debt Ceiling

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A quick nod to Bloomberg columnist Caroline Baum from whom we lifted our title. Anything else you might have been (or will be) subjected to on the subject of how the government operates pales in materiality to the headline. And as miserable as our predicament seems to anyone over the age of 13, it really and truly is old and increasingly dull news. To wit, I present the following, highly curated list of quotes-please note the timeline.

"One of the penalties for refusing to participate in politics is that you end up being governed by your inferiors." - Plato

"A wise and frugal government, which shall restrain men from injuring one another, which shall leave them otherwise free to regulate their own pursuits of industry and improvement, and shall not take from the mouth of labor the bread it has earned. This is the sum of good government, and this is necessary to close the circle of our felicity." - Thomas Jefferson

"Suppose you were an idiot, and suppose you were a member of Congress; but I repeat myself." - Mark Twain

"Democracy is the theory that the common people know what they want and deserve to get it good and hard." - H.L. Mencken

"You can always rely on the United States to make the right decision, but only after it has exhausted every other conceivable alternative." - Winston Churchill

Financial markets are either efficient or they aren't-even the Nobel Committee can't seem to decide as it recently gave prizes in economics to both Eugene Fama, one of the fathers of efficient markets theory, and Robert Schiller, one of the fathers of Bubble Theory. This apparent contradiction highlights precisely why sooner or later our innate lunacy naturally manifests itself in financial asset prices. The interesting relevancy here-in response to the "surprise" that financial markets didn't pre-collapse over the last month-is that we did that already in 2008. While markets may vacillate through periods of semi-efficiency, participants are wonderful at fighting the last war and the last war suggests that if Washington threatens true idiocy, markets will drop and "discipline" the process into pulling back from a perceived brink. Big drop, big rally, no change-so why bother trying to game that? I am not sure how far we can take this theory, but it is not an unreasonable supposition.

The last thing anyone needs to hear from Cove Street is another long soliloquy on the fiendishly simple solutions to moving our political process toward having a mere neutral effect on economic development. Congress has raised the debt ceiling over 90 times in 70 years, including 15 times since 1993 with no appreciable effect on the members' ability to rein in government spending and without materially impacting our ability to innovate and produce economic growth in the longer run, although we recognize the implicit limits of an otherwise intelligent statement at the margin. Let us all agree that legislatively committing to spend money and then not approving the ability to actually raise the money you agreed to spend is as unthinkably dumb as, say, the government encouraging, begging, and approving JP Morgan (which at the time was one of the few viable candidates) to buy Bear Stearns and Washington Mutual and then turning around and suing Morgan for the pre-existing conditions.

What also continues to be confusing for the chattering classes is the ability to relate the materiality of a problem with the size of the entity. Yes a $6 billion trading loss every quarter will start to add up, but it is hardly crippling for an entity like Morgan that is doing almost $25 billion in "pretax, pre-legal" income. And if losing $6 billion is now a jail-able offense or is worth suing someone over, then what about the following examples of misallocation of capital?

· Hewlett Packard and $10 billion for Autonomy?

· The $45 billion LBO of Texas Utilities executed by some of the world's most esteemed financial minds that is about to go into bankruptcy?

· Exxon and $40 billion for XTO Energy?

· Google and Motorola? Microsoft and ANYTHING?

· Most mining companies and their 2011 acquisitions?

· Fannie, Freddie, or the FHA?

Morgan noted on its last conference call that "80% of mortgage losses were related to WAMU and Bear" and "we just turned in a 100,000 page plan to regulators" and "we hired 5,000 people in compliance and those costs are not going away." Long live Steve Jobs and I have pre-ordered the Dimon memoirs on the Barnes & Noble website-believe me I can't wait.

Oddly enough, the weirdness surrounding the banking industry has been partially responsible for our outperformance this year and we continue to own a decent chunk of large cap banks, insurance companies and whatever Leucadia is. The sector continues to be feared and loathed within political circles, investors' portfolios, and the financial headlines. However, if one makes the controversial assumption that we are not returning to a world of shell and bead bartering, then we are not afraid of entities like JP Morgan that are being herded into being "Regulatory REITS" but whose valuation at 10% effective earnings yields is going to be a lot higher 5 years from now. Conversely, small cap performance has been helped by exactly the opposite bet as smaller banks do not have the manpower, skillsets, or scale to afford 100,000 page documents-nor do they have the diversity of income generation. We think this still makes sense and we continue to own banks…or not…in the respective strategies.

Another industry that has worked for us this year is energy. While we invest in a world where it is problematic to have "rules," we do have "leans" and one of them has been a wariness regarding investing in commodity businesses. The old adage "tell me what the price of the commodity will be in three years and I will tell you what you should own" is not an easy premise upon which to base a successful investment. But, what we have figured out over the years is that a change in capital allocation in what appears to be a pile of dreary commodity assets can be the basis for an excellent investment. In these cases there are often two components of the potential return: the benefits that stem from ceasing to do dumb things and eventually overcoming the amount of mental baggage investors attach to former management gaffes that inevitably penalize valuation longer and more deeply than seems reasonable. As an example, ignoring the current frenzy surrounding Pioneer Resources (into which we are selling), the investment started at $45 with some mild-by today's standards-institutional activism that produced a presentation that said: "we are going to sell off our far flung empire, stop trying to be the next Exxon and focus on our low cost, low risk, high return Texas acreage." Few believed the company at the time and while PXD has turned out to be THE prime beneficiary of advancements in fracking and drilling technology, that fact was not the intellectual basis upon which we predicated our investment. We think Chesapeake Energy falls into a similar investment category as well, along with Approach Resources and Emerald Oil in small cap. Under this paragraph's heading, we are also…choke…starting to poke around the gold world, as the valuations suggest as miserable a pile of investor sentiment as we have seen since 2008.

Moving forward, investors should be as concerned with insidious claws out-of-control regulation as they are with the real and secular burden on our collective desire to innovate and profit from it. We dragged this from the SEC's website:

The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.

Yet the SEC's big focus right now is forcing corporate America to disclose a ratio of CEO pay to a definition of median employee pay, a study that the SEC admits provides zero potential economic benefits. And we wonder why we have a dispirited middle class?

The other part of the world upon which we can do nothing about-but what truly concerns us-remains Federal Reserve policy. There is nothing in the Fed's historical record that provides any confidence in any forecast it makes, and a policy whose net goal is to encourage more risk taking in the general populace is problematic at best. (As always, please refer to hoisington.com for a scholarly view of the mess the Federal Reserve has assisted in creating.) But the tapering talk and its immediate effect on global asset prices this summer confirms several of our ideas. First, it remains a lot easier to give people free money than it is to take it away. It also turns out that the entire world has been feeding at the Fed's trough and it is abundantly clear that many investors are using parts of the stock market as a fixed income/bond surrogate rather than viewing the purchase of equities as representing long-term ownership of pieces of a real business. Thus "tapering" might have a much larger effect on equity prices than we had previously assumed.

We have no idea how much Federal Reserve-induced levitation is embedded in stock and bond prices, but it has done "something" to valuations and that something remains a very large and negatively-skewed known unknown. Unlike the dangerously naive view of the academic mandarins currently running economic and financial policy in Washington, any realistic assessment of the economic history of financial markets leads to the conclusion that markets over-react to change. Given the immense scale of Federal Reserve intervention in financial markets-and perversely, regulation specifically designed to remove the world's leading financial firms from their traditional role of acting as a middle-man between buyers and sellers-we would think that "change" in the future will be similar to what we witnessed when the Fed first whiffed at its chance to initiate appropriate policy movement.

So we continue to worry top-down but invest bottom-up, a process that is made more difficult by the practical problem that many equity prices we look at seem to reflect the high probability of a scenario that either requires a big uptick in growth or long-term, near zero interest rates. We are becoming increasingly more uncomfortable with either bet.

The conceptually bullish argument that equities remain the tallest investable asset in class in a room of very short alternatives is persuasive, but this concept has inevitable limits as it is inherently a relative value proposition, and umm…the rates of fixed income alternatives are likely 11-year-olds destined for a growth spurt.

NO ONE gets market timing right consistently enough to build a sustainable business-so we buy situational value when we see it and we sit tight when we don't. We are more in the "don't swing" mode as of this writing. We have tried to weed out holdings where permanent capital loss is possible and hunker down where we see only temporary "quotation" risk. We are not proud of ourselves for essentially saying the same thing for the last year in slightly more interesting ways. The difference as the year has progressed is that our ability to find cheap stocks appears to have been compromised by the general rise in the market. We remain patient and diligent in both our own portfolio as well as our assessment of the opportunity sets around us.

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