CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

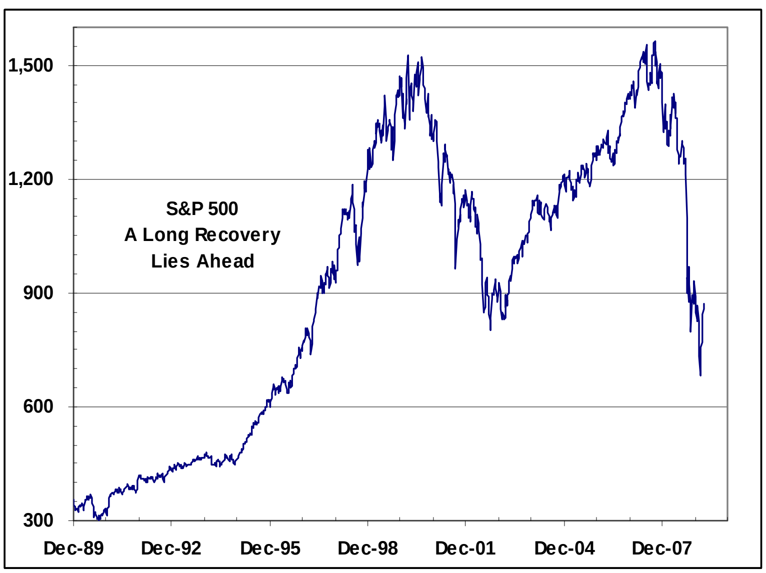
April 19, 2009

One Step at a Time

Although the economy will remain weak for a long time, financial markets are functioning more rationally now. We have begun a series of reflation-related investments.

Slowly, ever so slowly, things improve. The six-weeks long stock rally means something, but it is only one piece of the puzzle. More significant are improvements in fixed-income markets, in which the 'spreads'--i.e, the differences between yields of corporate bonds and treasuries--are narrowing. As price differences between treasuries and various types of corporate bonds narrow, we get a sense of progress toward "normal" pricing of investment assets. Although the economy continues in a terrible state, prices in investment markets suggest that the world's banking and credit systems will not utterly fail.

In the autumn, after the collapse of Lehman Brothers and the (now-questioned) rescue of AIG, there was well-founded fear that financial systems were unraveling. Mr. Bernanke, our Federal Reserve Board chairman, and Mr. Paulson, our then-Treasury Secretary, recognized the risk. So did our incoming President and his advisors. They sprang into action, as did a number of the world's other important central banks and finance ministries. Government and central bank actions have been designed to keep the banking and credit system functioning, or to stimulate economic activity, or both. The Fed has expanded its balance sheet enormously and become America's banker in ways necessary, but heretofore unimagined. To make up for the collapse of private banking and lending functions, the Fed buys commercial paper, extends its credit to private investment funds, and engages in other novel and utterly unprecedented banking activities.



In my view the Fed's actions and those proposed by the Treasury are needed and helpful. Because of the severity of the economic and financial system problems, many actions are indeed radical. Decisions have been made and policies undertaken under extreme pressures. Although some policies will be seen, in retrospect, to have been flawed and damaging, we are being well served by the activist approach. Doing little or nothing runs the risk of a much worse recession and of the collapse of the system.

By

Jack Mayberry

Investments. Core's investments since the autumn meltdown have been guided by two main views: First, the system ultimately will work and the economy will recover. Second, the crisis is not yet over. Thus, we are engaged in a careful balancing process: We are investing in assets that appear to be relatively safe and to offer good returns as the markets return to normal, while we husband large cash and bond reserves against further market turmoil.

Our investing in high-grade US bonds was the first step; we began it in December. We sense the beginning of the dollar's decline--which is, for better or for worse, also a return to "normalcy". We have begun to invest in Euros and we intend to take a position in the Canadian dollar. We have made small initial investments in Asian equities (specifically in Taiwan and Hong Kong) as play on China's reaccelerating growth. We made a small investment in gold, as a hedge against the dollar's decline and against the inflation risks posed by governments' economic stimulus spending. We made another small investment in large, financially strong US technology companies. (These business are hurt by the economic recession, but they do not depend on the banking system to fund their activities; in general, they have huge amounts of cash and no debt. Many industries have both problems; technology has just one and should continue to outperform stocks generally.)

We have a full set of planned future investments for the months ahead. The flow of economic reports and the markets' responses to these will teach us when the balances between risk and reward tilt in our favor for these investments. As everyone knows, the fantastic and horrible waves of selling of investment assets have offered up remarkable values; as risk subsides for these various assets, we plan to act and we expect good results.

Apart from investing in the Canadian dollar, mentioned above, we intend to build a position in lower-grade corporate bonds. We are close to taking the first step in this process. The low-grade, high-yield corporate bond investment idea is related to our investments in high-grade US corporate bonds. During the calamity of last autumn, every imaginable asset declined sharply, with the exception of the US dollar, the Japanese yen, and Japanese and American government bonds. High-grade corporate bonds (e.g., bonds issued by companies like Procter & Gamble and Johnson & Johnson) fell in price because of the generalized panic selling and the fears of the ultimate financial disaster. The selling created wonderful values in these bonds: companies like these may suffer from recession, but their ability to pay interest and principal on their bonds is not at risk. We have investments in them and we are earning a good return.

The bonds of riskier companies fell by much more in price. Their bonds are, indeed, riskier. Some companies will default in payments on their bonds and the recovery from these defaults will be less than 100 cents on the dollar. However, the market is now pricing the risk of defaults and the recovery rates at absurdly unrealistic levels. As time passes, the risk of Armageddon recedes and makes these high-yield bonds increasingly attractive. We expect soon to make an initial investment in these; we expect over time to build a reasonably large position in such bonds and we expect to earn very attractive returns from these.

The economy. A word about the economy: We read of 'green shoots' of economic recovery. Of course, it is springtime and the metaphor is readily at hand. However, we are losing jobs at the rate of 600,000 each month. Necessarily, this increases mortgage delinquencies and defaults and puts more downward pressure on home prices. The recovery process will be a long, faltering, and slow one. We can surely expect economic recovery, a functioning banking system, and appreciation in financial markets. We should not expect it too soon. Patience is still a virtue.

Problems in the banking and credit system are a long way from resolution. Mounting job losses will continue to hurt the economy and housing prices, and to threaten the solvency of banks.

These factors argue strongly for very cautious investing. We hold large investments in high-grade bonds, but only very small investments in riskier assets.

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