

CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

May 16, 2008

Inscrutable Risk

After an accelerating decline in the dollar of the value since the credit crisis began last summer, the dollar is beginning to stabilize. We sold our euro-currency position a couple of weeks ago, but still have a large position in foreign currency money-market instruments.

At the beginning of April, I wrote that the mid-March rescue of Bear Stearns by the Federal Reserve and JP Morgan bank may have been the climactic event in the credit crisis. In the weeks since, evidence to support this has piled up. Credit market conditions have improved, stresses in the banking system have subsided, fears of large-scale failures in the financial system have declined, and stock markets have improved.

This is all to the good. But, are the problems over? Has the decline in US home prices come to an end? Has the subprime credit market crisis of 2007 and 2008 come to an end and joined the ranks of previous financial crises, in which the worst was avoided and from which strong rallies ensued? It is too soon to say. It is premature to declare victory and to pile into risky investment assets.



At a press conference discussing the Iraqi war, Donald Rumsfeld memorably taught us that “There are known knowns. These are the things we know that we know. There are known unknowns. That is to say, there are things that we know we don’t know. But there are also unknown unknowns. These are things we don’t know that we don’t know.”

Whatever one may think of his abilities to plan and conduct a war, one has to admit that Mr. Rumsfeld’s observation applies to many things. Investment risk is one: There are the things we know that pose risk to investors, e.g., putting all our capital in the stock of a single unproven company. Among the known

unknowns that pose risk is the whole world of financial derivatives: we knew that something (or many things) would go wrong, but we did not know what these things were. But, in addition to the inherently undefinable unknown unknowns, there is a still more pernicious category of things to trip up investors.

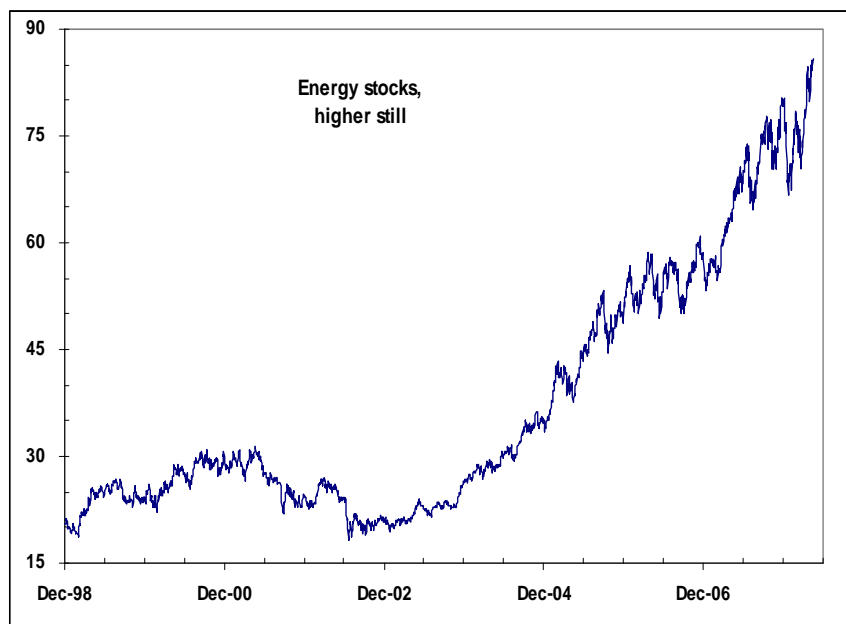
By

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These are unknown knowns, in which I would class those things that we think we know, but which are in fact unknown to us, or which we misapprehend. The investment world is full of things that everyone “knows” and that are utterly false and quite dangerous: In the ‘eighties, we “knew” that foreign stocks and US stocks did not move together and that foreign stocks outper-

Crude oil prices now exceed \$125 per barrel; we face the prospect of higher prices still. We have large investments in energy-related stocks and our portfolios continue to benefit from these investments.

Past performance is not a guarantee of future returns.



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formed US stocks. Thus, adding foreign stocks to a portfolio otherwise full of US stocks would lower risk and improve returns. But in the 'nineties, US stocks and foreign stocks moved in tandem, and, to make matters worse, US stocks outperformed foreign stocks. Adding foreign stocks to a portfolio increased risk and lowered returns.

More recently, investors "knew" that the stocks of developing economies in Asia, because they were not exposed significantly to American subprime mortgages, would provide a good hedge to US equities in the subprime crisis. Wrong. It was right that the economies of the developing countries were less damaged by US housing market problems. It was wrong to think that their financial markets would be spared the selling that would hit US markets. As things turned out, the emerging equity markets fell further in the first quarter of this year than did the US market, even though their economies went ripping along at high speed. It turns out that "hot" money had entered emerging markets in the last couple of years when the

riskiest investments provided the best returns. Then, when things got ugly, investors tossed out the gamiest stuff first. Entirely rational, but an example of the ease with which, in investing, one can "know" something that turns out to be unknown or false.

From these examples (or numberless others) about the 'unknowability' of risk, one cannot conclude that investing is some kind of mug's game whose outcome is decided by chance. The logic of asset prices and the consequences of risk generally become quite clear after the fact. To keep one's skin intact one has to maintain a clear awareness of the inherent subtlety of investment risk. More importantly, one must be aware of the severe consequences to one's capital if one does not fully appreciate this 'unknowability.' It is far better to admit that one cannot know how

all the pieces will fit together and to recognize that risk lurks around the corner. Danger comes when one blandly assumes that markets will follow one's thesis.

The application of these ideas to the present leads us to conclude that, although the Fed dealt effectively with the dangers to the financial system in its Bear Stearns rescue, the way has not necessarily been cleared for all risk investments. Appetite for investment risk has risen by lots of measures and risk taking has been rewarded since the Bear rescue. But, what is around the corner? Has the housing market hit bottom? (Maybe.) Has it begun to recover? (No.) Have we seen the full fall out yet from credit card debt and auto loans? (Doubtful.) What yet unforeseen credit market problems will emerge to upset the present optimism? Recall that in February, the fate of the world's financial system seemed to hang on the question of whether Ambac and MBIA, the previously obscure municipal bond insurers, would keep their (bogus) AAA credit ratings.

We have seen bear markets fall further and last longer than this one and we can imagine good reasons for a leisurely and painful unfolding of this whole mess. We continue to believe that our large holdings of US and non-dollar money funds make good tactical and risk-management sense. We fully expect stock markets to be higher in a couple of years, but they may stumble further in coming months.