INVESTMENT UPDATE
NEWSLETTER

ALLEN TRUST
COMPANY

MAY 11, 2011

William A. Harris, CFA
Chief Investment Officer

Distance to Safety

In the moment you don't have the feeling of great risk, but the feeling you have "found the tool to make it smooth." In several cases, Blücher says, he's found himself or expedition partners – elite, highly analytical paddlers – doing things that had no rational basis and were completely out of character... rookie mistakes like ignoring parts of their normal checklist for assessing a rapid. Usually these things occurred under a set of super-exposed conditions. "People all of a sudden… run off to attempt the most idiotic lines they would never attempt as their 'normal selves.' But then it may be too late."

Todd Balf, The Last River

Last Saturday flying home from meetings back east, I read Balf's account of a 1998 kayaking misadventure, an attempted first descent of the Yarlung Tsangpo, touted as the "Mount Everest of rivers" and the last, greatest whitewater feat yet to be pulled off.

The passage above quotes and paraphrases whitewater expert Lukas Blücher, who held back from trying the descent that season due to freakishly high water levels. By "super-exposed" he means supremely risky and posing an unacceptable "distance to safety" should something go wrong.

We find parallels in today's markets:

- High waters (S&P 500 at a 10-year Shiller p/e of 24 vs. a 16 historical average)
- Breadth of risk (bank-to-bank across asset classes, not much looks cheap)
- An inhospitable shore ("safe" bond alternatives unappealing – treasury yield curve artificially low, and credit spreads narrow)
- Major sub-surface turmoil (rising commodity price volatility and margin pressure from higher input costs)
- Support from would-be rescuers looking shaky (due to monetary and fiscal energies already exhausted upriver)
- Extended period exposed (market's surge almost unabated since August)

This last point relates to Blücher's observation that particularly on long expeditions in potentially deadly water, one's perception of risk degrades – adrenaline and the self-assurance that you've "found the tool to make it smooth" come to overwhelm common sense.

Here's common sense to us: Stock prices are abnormally high relative to normalized earnings. Profit margins are seductively fat, but "unless capitalism is broken" (to borrow a phrase from Jeremy Grantham), competition means they'll revert lower. Stock dividend yields are abnormally low, though there are some bright spots to be found here (Intel just raised its dividend 16%, the second hike in six months – bravo!). With bond yields nearing the zero bound, appreciation will be scant unless negative real interest rates prove durable or we slip into a massive deflation. In short, not much looks priced to put cash in your pockets reliably and sustainably.

So what do we do? Abide by our investment checklist. When it says to, stay out of "the surging main channel far more treacherous than it appears from shore" and ply the tamer edges instead. Where a stretch of river looks bad across its breadth, be willing to haul out and hike. Try to see things for what they are, and not what other investors' adrenaline tells us they look like.

Blücher's assessment of the Tsangpo's conditions as super-exposed kept him from trying for glory that season. It also kept him and his teammates alive.