CLEARVIEW
INVESTMENT PARTNERS, LLC

March 2013 Volume 3

"*I am for doing good to the poor, but...I think the best way of doing good to the poor, is not making them easy in poverty, but leading or driving them out of it. I observed...that the more public provisions were made for the poor, the less they provided for themselves, and of course became poorer. And, on the contrary, the less was done for them, the more they did for themselves, and became richer*." - **Benjamin Franklin**

# What Is Money?

You may know where your money is, but do you know ***what*** it is? Whether you are an engineer, salesperson, teacher or coffee house barista, you likely go to work most days and at the end of a week or two you receive a form of payment that represents compensation for the goods or services you've provided. We generally regard this payment as money. It is a medium by which we can conduct our daily affairs. Now, in a building somewhere in Washington D.C. or N.Y the authority is given to push a computer button and create $1 trillion; *no work, no services, no goods.* Is this money? Is this moral? Do you know what money is?

**Figure 1**

It's the ***math*** that matters. Now before you cringe at that four letter word, understand that without it there would be no computers or cell phones, no movies, flight, or even widely distributed food for that matter. But the math I'm talking about is the math of excess. Specifically the excess of money being thrown at our problems without regard to the destructive side effects, never mind that they are destined to fail in time. Now, I don't claim to know the right size for government, but I'm pretty sure size is ***not*** the issue, efficiency is (put simply, would you rather have a small car that gets 10 m.p.g. or a midsized car that gets 28 m.p.g.?). With regard to market dynamics, the new math seems to work as described in ***figure 1*** above, where ***a*** is printing money and ***b*** is higher stock prices. Seems pretty simple, and it is. The question then arises, why haven't we done this before? And the answer is that there can be no *sustainable* wealth created by just running a printing press. There is no value creation, and hence no wealth creation. True wealth is created when we invest in new ideas or make old ideas more productive. It is created when, through hard work and determination, a new business thrives by providing a useful service or eliminates an unpleasant task long burdening the populace. So the wealth that seems so easily conjured up by massive amounts of money printing and deficit spending is fleeting. The *math is flawed*. The reason we know this is because these type of *experiments* have been tried before and have proven to have very spotty, if not downright horrible, track records. Minor devaluations (devaluation of currency or purchasing power comes from the decline in value of money as money becomes more abundant than goods and services) seem to occur frequently throughout history and create some trading advantages, but the type and size of money creation we've witnessed globally in recent years is only accelerating and has a formidable record of disaster. (see: Sovereign Defaults).

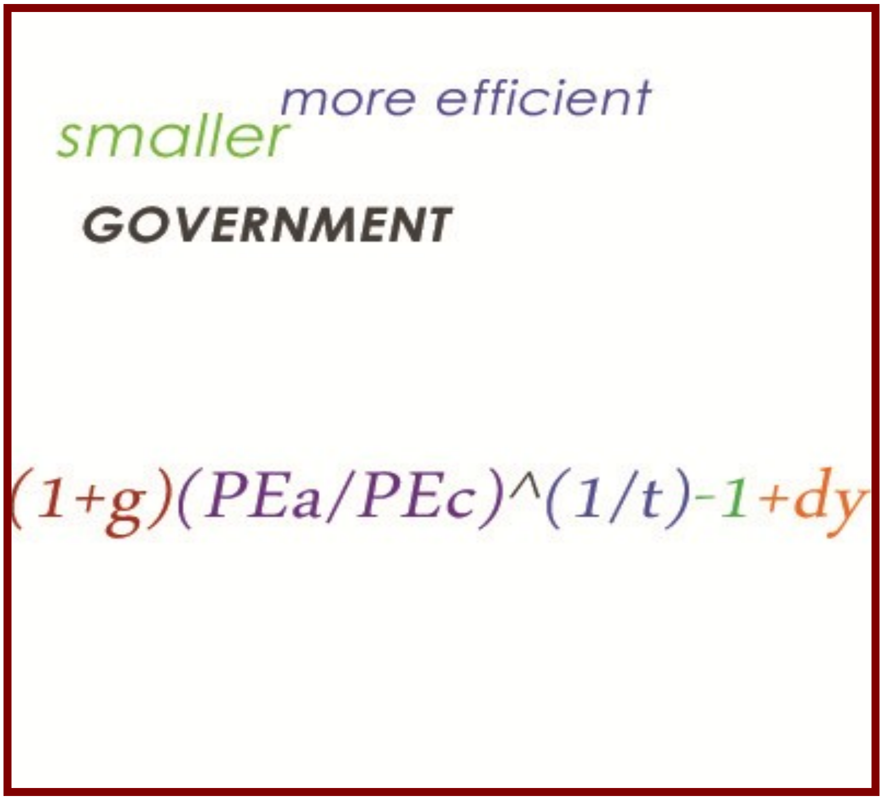


**Figure 2**

The math that makes us much more comfortable with future returns and is rooted in base fundamentals is shown in ***figure 2*** . Without going into all the gory details it simply takes into account the long-term growth of the economy (g), normalized long-term earnings trends and price to earnings (PE) trends, time values and dividends (dy). Things that really matter in a sound running economy. Implicit in these factors are investments in infrastructure and buildings, machines, workforce training, intellectual property and a myriad of other things that we seem to be doing too little of right now. These observations are critical because they shape how we invest our clients' capital. If we were to assume that the recent 3-year returns in stocks will continue unimpeded while the Federal Reserve continues to pump money in the system, what are we to think the markets will do once they reverse course? Many investors have been conditioned to buy only with the Federal Reserve in easing mode, who will buy when they tighten? Already risk premiums (the excess returns expected from stocks over treasury bonds) are at the some of the lowest levels I've seen in my career spanning 25 years. This is at a time when the risks to the system are more elevated than at any time during that period. If we take the long-run nominal growth in the economy of 6%, a PE of 16 on normalized earnings (vs. 22 currently) and dividends of roughly 2%, the math shows us to expect roughly 4.1% annually from stocks over the next 10 years. Could we see a better outcome than that? Sure, but it most likely won't come in a straight line. For stocks to offer more normalized long term returns in the 8% range the S&P500 would have to decline to about 1000, or a 33% decline from today's price. Another option would be if the S&P500 stayed at it's current level over the next 5 years while the economy continued to grow at its long run average. Because we believe it is highly unlikely for the stock market to just 'level out', our justifiable concern is for a correction that can cause plenty of pain for the un-annointed. It's this reason we continue to patiently hold slightly elevated cash balances for our clients' accounts.

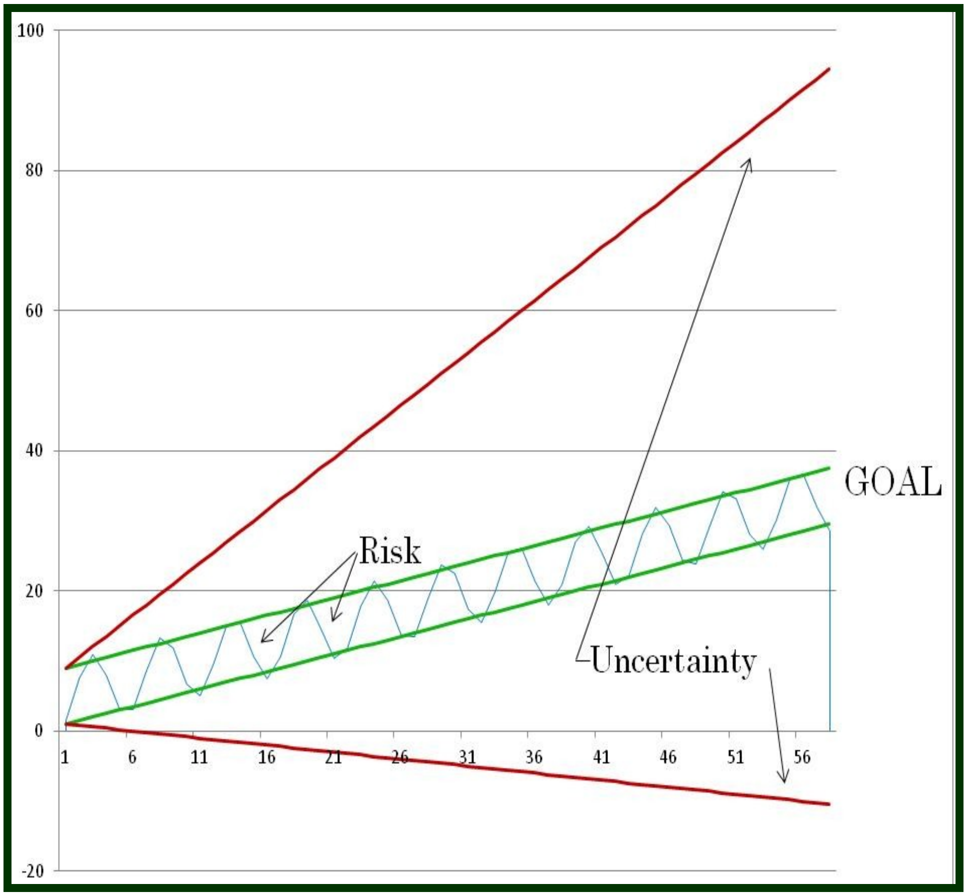


Figure 3

To understand the difficulty of modern day wealth advisory, consider the graph in ***figure 3***. Historically, a client would outline their goals and ambitions and set out a timeline in which they wanted to try and achieve them. After careful consideration of their risk tolerances and other factors a strategy could be implemented to set the target for saving and investing toward those goals. The likely outcomes and framework looked a lot like the parallel green lines in our graph. The risks we knew were there could be managed, although not entirely eliminated. The red lines in our graph represent the likely outcomes of uncertain events. They've always existed, however, their range was more narrow and their occurrence more unlikely. Today we have a situation where the uncertain events have become more probable and the range of outcomes more widely distributed. Of the more probable uncertain events we include inflation, hyperinflation, deflation and war. Why? Principally because of global over indebtedness, central bank interventions, currency debasement, trade wars and fiscal mismanagement. The outcome of each will affect a portfolio of assets very differently. In the event we experience one or several of these over the next decade, standard portfolio construction returns may seem like just a rounding error. It is wise (although not entirely painless) to have a plan where highly liquid assets can be deployed quickly when an opportunity arises because of illiquidity and fear in the markets.  For the time being none of these uncertain events or fears are present in the marketplace (in fact, maybe just the opposite; one of euphoria).  Subsequently, the opportunity set is limited.  That has not stopped the Federal Reserve from having a policy that leads to gross misallocation of capital, so long as they feel that the side effects will be overwhelmed by genuine growth in the economy.  There is a dangerous set of assumptions in this prescription, however, I will point out that the powers that be have very few options at this point.

Whether we agree with current policy or not, one of the observations we've made with respect to further increases in asset prices relates to continued Federal Reserve easing.  We are now seeing the effects in the real estate market where prices in the Case-Shiller 20-city composite index have increased approximately 6.5% year-over-year.  If the strength in home prices continues, it adds another level of underpinning to the languid recovery.  Selectively, we've also identified the biotech arena as an area of interest because it rests on a sound foundation of continued research and discovery particularly as it relates to DNA and the human genome.

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