TFC Financial Management

TFC Market Update
May 14, 2012

Another Icon Tarnished

In today's *agency* world, we turn to experts to guide us through the interconnected maze that has become the international world of banking and investment markets. Sad to say, another guiding light in the too-big-to-fail commercial banking cosmos, JPMorgan Chase Bank Chairman, Jamie Dimon, has been proved to be only human after all. During the past few months, JPM's London-based trading desk placed a series of transactions totaling $2 Billion (2% of the bank's entire "risk management" portfolio) which were intended to " . . . protect the bank's balance sheet." But the markets moved against this hedging *bet*, and JPM stakeholders have been put at risk, if not in peril. Had this happened to a less well capitalized domestic bank, U.S. taxpayers might again be sponsoring another bail-out. In this instance, unless other miscues emerge, the damage is confined to Jamie Dimon's and JPM's reputation, its employees and shareholders. How could this happen to the one banking institution in the world which weathered the 2007-2009 meltdown unscathed, and to Jamie Dimon who emerged as this nation's pre-eminent spokesman for sensible banking practices?

What appears to have occurred is that the "experts" at JPM, probably following computer-based, mathematical financial models which sacrifice reality on the altar of elegance, failed to remember that human behavior often trumps logic. Even Jamie Dimon, who we must assume sanctioned his London office's hedging tactics, seems to have ignored the extent to which his institution had been placed at risk.

In this instance, the concern is that JPMorgan's trades were not just placed in the ethereal market for alternatives and synthetic financial instruments, but that because of the magnitude of these wagers, they themselves became the market. It may take weeks, if not months, to unwind these positions, during which time Congressional hearings will dramatize why closer regulation (e.g., "Volcker Rule") should be implemented.

In finance, as Jason Zweig of the Wall Street Journal in his most recent article points out, the biggest danger is self-deception. Computerized, quantitative refinement for the expert can often be intoxicating. When in the position of a fiduciary, failing to question one's own beliefs is an especially dangerous deception.

Readers of these interim comments, and our quarterly letters, will note a common concern on our part about the ability of active, "expert," stock-picking portfolio managers to outperform the markets. The seemingly immutable statistical investment maxim is that all market phenomena tend to revert to the mean. Peter Lynch of Fidelity's Magellan Fund understood this and escaped his 13-year better-than-market performance run with his reputation

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intact. Bill Miller of Legg Mason, after 12 years of similarly impressive results, thought he could beat the odds, but was humbled by a series of sharp reversals that followed. Hubris has no role when managing other people's money.

<u>What Should We Be Questioning Today?</u>

One question which, although investors haven't paid much attention to it yet, seems inevitably to require resolution is how will the 2013 "fiscal cliff" dilemma be dealt with by our apparently dysfunctional political class in Washington. Preoccupied with the Eurozone-Greek tragedy unfolding minute-by-minute, the equity markets at present appear to be paying little heed to the unsettling prospect that on January 1, 2013, the U.S. faces the largest income tax increase in its history. Viewed from the left or right, today most are treating this threatening bite out of the U.S. economy as if it were another Y2K non-event. The final weeks of 2012 following November 6th promise to be traumatic at best, catastrophic if political gridlock continues.

Meanwhile, step-by-step, most states, governors, legislators, and citizens are revising programs and budgets, and adjusting spending patterns. Personal, corporate and state balance sheets are under repair. Unsure of how burdensome the unwinding of the Federal government fiscal mess will be, all parties are building cash reserves. The Federal Reserve Bank continues to print money, adding liquidity, which finds its way into the investment markets and into bank reserve accounts, not where intended to stimulate the real economy. Until visibility beyond the fiscal cliff clears, few seem to be willing to make meaningful expansion and employment commitments.

At the moment, the direction in the global equity markets seems to be weakness bordering on correction. Beyond this year, as long as corporate earnings growth continues its improvement, as has been the case since the third quarter of 2009, the case for equities holds up. For fixed income as an asset class, foregoing some income in favor of principal protection through ownership of high quality, short duration positions continues to be the prudent course.

Should you have any questions or comments, please let us know.

Best,

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