The Long & Short of It

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Is There a Way to Hedge Against, or Profit From, Big Government?

Over the last decade, the capacity of domestic stocks to create wealth has been increasingly challenged. The implication of a government that over-reaches in the scope of its duties - attempting to do too much and thus not doing well at the important things - is that it falls short in providing an environment that promotes the nation's wealth.

What follows is an introduction to Robinson Value Management's inquiry (15 years, so far) into the questions we wish to answer most: "How should our investment process be positioned to take advantage of current market opportunities?" More specifically, "Is there a way to hedge against, or profit from, big government?"

We have identified patterns in capital markets that we believe are driven by behavioral responses to governmental activities. Since 2003, we have used some of these patterns in an investment strategy called Market Opportunity. The larger government becomes, the more profitable the patterns should be and the more important it will become for investors to find ways to augment the less-than-optimal returns from traditional investment portfolios.

The Challenge

Most equity indices remain below where they were in early 2000. Of course, digesting the excessive optimism and pricing during the dot-com bubble was going to take time; however, it has now been almost 13 years of equities in purgatory. As value investors, we know that book value and earnings continue to rise and that stock prices will eventually follow. In fact, because current valuations are so much lower than in 2000, one would have to conclude that the next decade will likely be better for investors than the last. Yet, ahead of us is an aging/retiring workforce and an over-leveraged government balance sheet that must go on a diet. It is not a recipe for growth, especially if government continues to miss the mark on releasing the creative energies of its able-bodied and able-minded population.

It is not just the post-crash deleveraging or the digesting of sins of the bubble years that has caused publicly traded stocks to suffer. It is also the increasingly uncertain and demanding regulatory environment as well as some old-fashioned crowding out that continues to weigh them down. It is hard to know whether the greatest threats to wealth creation come from the scope and complexity of regulation or the permanent uncertainty of the regulatory landscape. Indeed, recent legislation frequently contains instructions to the regulators to conjure reams of additional new rules over subsequent years. What business manager or investor can get excited about risking his capital in the face of such uncertainty?

In Federalist No. 62, (1788), James Madison warned Americans about the dangers of uncertainty in their nation's laws, saying that:

> *It will be of little avail to the people that the laws are made by men of their own choice, if the laws be so voluminous that they cannot be read, or so incoherent that they cannot be understood…. What prudent merchant will hazard his fortunes in any new branch of commerce when he knows not but that his plans may be rendered unlawful before they can be executed?*

There is a symbiotic relationship between the public and private sectors. The public sector requires a successful private sector in order to survive. The private sector needs an environment conducive to wealth creation. This means having a public sector that provides for defense, civil law enforcement, protection of individual and property rights, and an infrastructure that promotes travel and communication. Since adopting a Keynesian approach, the ebb and flow of government activities has leaned toward continued expansion, especially during the non-bullish periods in the economic cycle.

What We Do

As the size of government in the United States has expanded in proportion to the overall economy, its normal activities increasingly impact financial and capital markets, causing systemic risk to alternate between "headwinds" and "wind in your sails" markets. We believe that government policy-making and execution create observable, predictable, and profitable patterns in stock markets that investors can use to their advantage.

Robinson Value Management develops and implements investment strategies with the goal of taking advantage of this macroeconomic environment. While we continue to employ traditional, fundamental security analysis for our stock and bond portfolios, we combine those strategies with one that analyzes financial and capital market responses to government policy-making and execution. So, we consider both company-specific risk and government's influence on systemic risk to build and manage portfolios.

The United States government is a large bureaucratic system. The breadth and scope of its activities are vast, affecting markets in many ways, including investor uncertainty and market liquidity. Governmental activities that impact *uncertainty* tend to be activities that involve command and control. Governmental activities that impact *liquidity* center on government cash flows. Governmental activities require reliability and predictability. These systems, over time, allow and even reinforce patterns in aggregate behavior. As government evolves, these behavior patterns become more entrenched. With the growth in the size of government, these patterns exert a greater influence on capital markets.

We have identified around a dozen of these patterns that are combined into a market timing strategy, which we began to implement in 2003 named Market Opportunity. Market Opportunity establishes long or short positions in the S&P 500 through Exchange Traded Funds (ETFs), reversing position 3-7 times per year. The Market Opportunity strategy also maintains an allocation to either long-term U.S. Treasuries or small-cap gold mining stocks, through ETFs, to hedge against drops in stocks accompanied by detrimental shifts in expectations for economic deceleration and inflation. Because it is engaged in market timing, we only use it as fraction of a traditional stock portfolio. Again, we believe strongly that the best way to earn money over the long run is through participating in private sector wealth creation through ownership of stocks and by owning bonds if you have a short time horizon or need more income.

There are two ways to implement the Market Opportunity strategy: (1) matching it as a small portion of an overall portfolio that RVM manages or (2) combining it with one of your own choosing. To provide for the first, at the end of 2011, Robinson Value Management introduced the WEALTH OF NATIONS™ strategy, which holds 70% in RVM's Contrarian Value Equity and 30% in Market Opportunity. For many of our clients this represents an ideal blend of low-volatility stocks combined with active market timing intended to take advantage of systemic risk driven by behavioral responses to governmental activities. The name for this strategy was inspired by our research into the role of government in promoting private sector wealth creation discussed in Adam Smith's book, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776). Others may prefer to build their own "wealth of nations" portfolio, holding on to their current basket of stocks and bonds, but making use of Market Opportunity for the ballast that it can provide to their overall portfolio. Please join us as we explore ways that investors can meet the challenges of today's environment and more successfully cultivate their wealth and that of our nation.

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