America: Not Built by Risk Management

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Dear Fellow Investors:

After 31 years in the investment business, I have come to the conclusion recently that we have become a nation of risk adverse people being led by a risk adverse group of financial industry professionals. What would the US have been like if many of the best minds in the country had always been devoted to reducing risk or risk mitigation?

British citizens moved to the American colonies in the 1700's. After an extended period of time, these pioneers became frustrated by taxation without representation. Good risk mitigation would have argued for seeking political representation in England and possibly going long an exchange traded fund (ETF) which would appreciate if taxes rose. Why on earth would you want to give up the protection of the most powerful nation in the world with the most powerful navy? Instead, we fought the Revolutionary War with an undermanned army led by a General (Washington) who had wooden teeth and wore a wig full of lice.

Once the US gained its independence, people were fool hardy and began to settle in the wilderness of America. My great-great-great-great grandfather and grandmother settled in Southeastern Indiana in 1796. It was called Indiana because it was controlled by Indians. They were allowed to buy property soon after for $3 per acre by an Act of Congress in 1805 called the Dufour Act. In other words, anyone foolish enough to risk their lives to settle there was given favorable terms. Today's advisors would point out that the Case-Schiller Index of property prices indicated that prices can fall lower and that settling Indiana wasn't a good idea because of the risk they were taking.

In the 1850's, strategic asset allocation would have argued the virtue of having one area of the country with legal slavery (the south) and one slave free (the north). The best financial move was to live in the North and stay long cotton futures in case slavery ended up being a bad business proposition. Why fight about it in the Civil War (1861-1865) and kill roughly one out of every twenty US males in the process? An ETF could have been created to be long the part of the country you disagreed with to reduce overall risk.

Germany and Austria declared war on Europe in the summer of 1914. It became a World War. The US sent its "Dough Boys" over in 1917 and the Allied Armies defeated Germany to the tune of millions of dead soldiers. When Pearl Harbor was bombed in December of 1941, we entered World War II. We sat by for years and watched a totalitarian dictator (Adolf Hitler) oppress millions of innocent people and left our strongest allies (Britain and France) hanging on the edge of destruction. To reduce risk and save our soldiers lives we could have invested in the German stock market double long ETF. Imagine how much more profitable German companies would have been had they held control of Europe! Why would you want to risk American lives in those situations?

Today, investors mitigate risk by investing in a country with a totalitarian communist political regime which prevents political, intellectual and religious freedom. This regime must present the façade that the GDP growth in their country is uninterrupted. In the process, China's strategy has driven the price of commodities like Oil, Copper and Cotton through the roof. Investors hedge their risk by owning commodity index ETFs. If the 1.1 billion people in China who aren't benefitting from "Red Capitalism" get exposed to the downside of capitalism (bouts of recession and depression), they might realize that there isn't opportunity for those outside the political and military ruling class! Good risk management argues that we shouldn't be the ones to tell them. Who cares if the myth the Chinese are perpetuating and the massive over-capitalization of the BRIC trade is probably the biggest hindrance to US economic recovery?

Almost three trillion dollars sit in money market funds and US investors are over-weighted in bond funds at the lowest interest rates in fifty years. Sophisticated investors and institutions screen constantly for minor statistical advantages with trillions of dollars. They also go the extra mile to avoid the possibility of the next 2008 stock market meltdown. We are very excited about the fact that our country was made great by taking risks and betting on the future. We are even more excited about taking risks on outstanding companies and avoiding ones that would appear to be popular due to the current risk aversion. At Smead Capital Management, we think folks should be excited to take good risks, just like our ancestors did and spend a little less time, money and energy on risk mitigation.

Best Wishes,

William Smead

This Missive and others are available at www.smeadblog.com.