"Buffet Bullish on US Economic Growth"

A TAMRIS Perspective on Warren Buffet's comments in the National Post 7 February 2007

The following is in response to the article "No Economic Bailout Necessary, says Buffet" in the National Post 7 February 2008 and comments on Jonathan Chevreau's the Wealthy Boomer.

Buffet is a valuation driven investor and he has not been averse to holding cash when he can find no viable purchase. This would be classed as market timing by many but is in truth nothing of the sort.

His Berkshire Hathaway fund is also a very long term investor, with a far longer timeframe than most individual investors. If we look at the date quoted in the main article, 1790, this encompassed the long recession from 1873 to 1879, the late 1920s and the depression era and the long period of poor real market returns (ex dividends) from the late 1960s to the early 1990s.

We are now in the 9th year of the current decade, a 9th year in which the real value of the S&P 500 is still significantly below its 2000 peak; since most investors fail to even earn the average return many will be in a far worse situation. Valuations and time frames matter and Buffet knows this.

He has successfully managed the risks of the market and the economy through his focus on valuation, by taking on specific stock risks which he feel offers value and by avoiding the market and economic risks of the index. This does not mean that he does not focus on the economics, since the micro factors impacting a stock's earnings are indeed the firm's economics.

He does not possess a blind indifference to what is happening, but he is blindly indifferent to what others are feeling or doing in terms of their own stock selection and buying and selling decisions. This is what he is saying when he says "turn off the stock market". He is not saying "ignore valuations" or price movements. He is supremely focused on the price of a stock because this is directly related to the intrinsic value of a stock, so whatever the market as a whole does to the value of a stock he holds or wants to buy, he is interested.

I would disagree with Warren about comparisons to 1982. He said that interest rates were at 21%. But price earnings ratios were much lower and earnings yields much higher; the S&P 500 had an earnings yield of 12% and a P/E of 8 in the early 1980s (with depressed earnings because of a 16 month recession starting in July 1981 and ending in November 1982) and a market yield of 5.5%. This was a screaming buying opportunity where all the risk was in the price.

July 1981 to November 1982 was a recession in the US, following on from a small 6 months recession in 1981. Since the end of the 1982 recession we have seen the longest and strongest economic expansion in the US since records began; the 1990/1991 recession only lasted 8 months as did the 2001/2002 recession,. In fact, 1982 marked the start of a consumer led economic expansion with personal consumer expenditure as a percentage of GDP (adjusted for changes in disposable personal income) at a post war low.

Today's US economy was imploding with interest rates at 5.25%. 1982 was as close as you could get to a multi decade low for market and economic valuations and represented a low point of a long bear market and the starting point of one the longest and strongest bull markets in US history. The current S&P 500 P/E ratio as of the end of January 2007 was 17.54 times earnings and the yield was 2.09%. This gives an earnings yield of 5.7%, half that available as of the start of 1982 with dividend yields on average 37% of 1982 levels and this is based on peak cyclical earnings (less the recent adjustments to banking stocks earnings, which admittedly represent earnings that should not have existed in the first place).

If we are at the start of a period of lower growth and higher inflation, earnings growth rates will fall, P/E multiples will decline and market returns will be below average.

Consumer debt as a percentage of GDP in 1982 was 48%. As of 2006 it stood at 98%. In 1982 personal consumer expenditure (PCE) as a percentage of Disposable Personal Income (DPI) was 86%, today it is 96%.

Just for the sake of analysis, if we take Warren Buffet's 21% interest rate figure for 1982, this is 4 times 2007's peak of 5.25%. If we adjust interest rates for personal debt levels (personal debt in 2007 was 2 times 1982's level) we find the effective interest rate multiple is only 2 times – that is 4 divided by 2.

If we then adjust for the fact that disposable personal income less personal consumer expenditure in 2007 was 27% of the figure in 1982, we find that effective interest rates for individuals with an average personal debt level are now twice the level they were in 1982 (27% times 2 = 50%); based on the relationship analyzed.

1982 was the end of a long period of below average market and economic returns, 2007 could well represent the peak of a period of above average market and economic returns. Over the very long term, this may well be of marginal significance, but for those living in the here and now it could be of immense significance.

Additionally, I would not be so sanguine over a) the amount of credit available in markets nor b) the fact that credit is no longer available to many of the previous buyers. Much of the growth in money supply and hence debt has been focused on assets and off balance sheet assets in the case of banks. As credit becomes less available, the price of many of these assets will fall impacting on so many other relationships. In the end Buffet is correct, this is just a demand/supply imbalance, albeit with significant short term implications.

Buffet states that he is a huge bull on the American economy by referencing a period 1790 to 2007, a period over which the returns from economic growth eclipse any short term economic risks. He may well be correct in terms of this type of time frame. I am bullish on long term real economic growth but am expressing considerable concern over short term problems. Over time the economic demand/supply imbalances will work out, but this does not mean that there will not be pain in the interim.

It is also worthwhile remembering that not everyone holds a Buffet portfolio and not everyone has the luxury of a 220 year investment horizon. If I was a long term investor with no financial liabilities arising over the next 15 years equities would be my preferred asset class relative to cash and bonds, but I would be mindful of valuations in determining where I put my money.

Buffet may also hold emotions at bay, but he can only do this because he thoroughly understands his own valuation paradigm. He does not care whether a share rises or falls, what he cares about are the earnings a company can deliver and a share price in the context of the price of those earnings. His asset allocation stance is sensitive to a different set of indicators than most who are in the market but this does not mean that he is blind to what goes on around him.

It is also worthwhile noting that Buffet is also at odds with strict academic interpretation of modern portfolio theory, which, has a much more dogmatic rationale for avoiding market timing and holding prescribed long term asset allocations. In this context, you can indeed be blind to what goes around since markets are efficiently valuing return and risks to return; unfortunately MPT and efficient market theory are not entirely representative of the real world.

In the end Buffet entered the current market downturn with a long term portfolio he felt held value. As prices fall, the investment universe becomes cheaper and less risky on a long term view, but only if you entered the downturn with an appropriate portfolio of assets, a disciplined valuation framework and a long term perspective.

Perhaps the better perspective would be what would Buffet do with many of the portfolios currently held by private individuals?

I am not concerned about investors with well managed portfolios held together by disciplined processes and, I am certainly not concerned about Buffet and his portfolio of assets, this as far as much of the retail financial services market place is not the issue.

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