

# Quaker Quarterly

## Indiana Jones vs. Tao Jones

*Quaker Capital Management is a registered investment advisor. We follow an opportunistic value-oriented discipline in managing equity portfolios and hedge funds.*

### Excerpts from this quarter's commentary:

*“In carving furniture, the more you carve the wood, the weaker it gets.”*  
-Lao Tsu

*“An investor can basically throw a handkerchief over prospective returns from various asset classes of between 4% and 7%.”*

*“If the reward among multiple choices is the same, take the lower risk option.”*

### Market Statistics

First Quarter, 2007

	<u>Return</u>
S&P 500 Index	0.18%
Dow Jones Industrials	-0.87%
NASDAQ Composite	0.26%
Russell 2000	1.66%

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-Lao Tsu

“The Mother River of China,” the Yellow River, is the second longest in all of China and has played an important role throughout the country’s history. It is estimated that 1.6 billion tons of silt are carried annually down the river, a deposit that over the centuries has caused the river to flow above the surrounding farmland, making flooding a dangerous problem. Various records indicate that since 602 BC, the levees surrounding the Yellow River have been breached over 1500 times. This flooding has caused some of the highest death tolls in history. It is estimated that in excess of one million people perished during each of the Huang He floods of 1887 and 1931.

Over the centuries, there have been two basic philosophies in China regarding managing the consequences of periodic flooding along the Yellow River. Financial risk managers might refer to these floods as two or three standard deviation events. The Confucian approach emphasized building large dikes and levees around the river, in an attempt to control or manipulate nature. The Taoists, conversely, believed that while dikes and levees may reduce the flooding in average years, they tended to exacerbate the consequences when major flood events occurred. For Taoists, the country was best served by letting those cycles take place while focusing on managing people’s behaviors rather than nature’s cycles. Acknowledging that nature would have its inevitable cycles, they recommended keeping human habitation away from the flood plain.

We see a very similar parallel in the conduct of monetary policy in our country since the 1980s. In 1987, 1990-1991, 1998 and 2001, the Federal Reserve provided liquidity to financial markets, akin to the Confucian approach to flood control around the Yellow River. Rather than let the financial markets periodically purge themselves of excesses in the natural cycle of markets, the Fed’s policy of crisis intervention, providing liquidity in turbulent markets, is an asymmetric policy which has resulted in an unnatural extension of the credit cycle. The implosion of the sub-prime mortgage lending market of the past few weeks may be one manifestation of that policy. As equity and credit capacity

continued to build in the financial system over nearly 16 years, certain financial institutions and investors moved further out the risk curve. In the mortgage market, financial institutions increasingly made home loans to people without evidence of documented income to support such lending. There were approximately one trillion dollars of sub-prime and Alt-A mortgage originations in both 2005 and 2006. ISI Group estimates that 46% of all home purchases last year were made with less than a 5% down payment. Of note, this hemorrhaging in the sub-prime market is occurring while the inventory of new homes on the market is already the highest in 16 years.

Perhaps a generation from now, with the benefit of hindsight, we will truly know the impact of the Fed's crisis intervention approach to monetary policy of the last 20 years. Whether, like the levees of the Yellow River, the policy mitigated problems in the short run while creating the unintended consequence of increasing risk in the long run. Like the buildup of silt along the Yellow River, we may have inadvertently increased the use of leverage in various forms in our financial system by providing liquidity in turbulent markets.

Whether this condition is attributable to asymmetrical Fed policy, or other reasons, the consequence is that investors have lowered hurdle rates for risky investments and returns for various asset classes have converged. This willingness to lower hurdle rates for risky investments is evident throughout the financial community. Consider the shape of the yield curve. Investors taking no interest rate risk are getting 5.25% in overnight Federal funds while those taking ten years worth of interest rate risk in U.S. Treasuries are receiving 4.6%.

Venezuelan sovereign debt that finances the government of Hugo Chavez, trades for a yield of just 6.9%. In the real estate market, certain office buildings in midtown Manhattan are selling for \$1000-1100 per square foot, a going-in capitalization rate as low as 3%, only five years after September 11, 2001.

Were we being paid double digit returns to take risk in financial markets, we would likely have a different view. However, the Value Line Index P/E ratio is 18.1 or a 5.5% earnings yield, not much different from the 10 year Treasury of 4.6% or Venezuelan debt at 6.9% or the Fed Funds rate of 5.25%. An investor can basically throw a handkerchief over prospective returns from various asset classes of between 4% and 7%. If there are two routes to drive that will result in the same time of travel, one a shorter distance over a treacherous mountain pass and the other a safe interstate that is more mileage but bypasses the mountain, who other than the adventurer would take the mountain pass? If the reward among multiple choices is the same, take the lower risk option.

The phrase, “wu wei”, in the Chinese language, translates to non-action. One of the most difficult things to do in the investment business is nothing. For one, it makes us feel as though we are not doing our job when we are not taking action, especially in the sometimes hyperkinetic culture of the United States. We are a country that admires bold action, courage, and aggressive risk-taking, as seen in characters like Indiana Jones. Our superheroes in comic books and in real life tend to be characters of action, but at times the optimal decision in the investment business is one of non-action, a policy of buy and hold or leaving funds in risk-free money markets. In what could be considered a “wu wei” approach

to investing, Warren Buffett has often recommended that amateur investors have a punch card of twenty holes representing the number of investment decisions they should make in a lifetime. Admittedly, we probably used up that punch card in our first year in the business. Nevertheless, a strong argument can be made in favor of making fewer investment decisions in more of a buy and hold approach. Ironically, this approach requires not only a high level of discipline, but also the courage to do nothing. Few investment professionals can execute such a strategy. That said, we suspect that it will be a long time before the next hit comic superhero is named Captain Lethargic.

This is not a time to be a superhero. We have a few good large capitalization ideas that we are maintaining, but the 16 year credit cycle may be turning down. Put another way, we want to build our investment portfolio far from the banks of the Yellow River. Generating a 5% return while waiting for better entry pricing for common stocks is quite competitive with 6.9% on Venezuelan bonds or 3% from Manhattan office buildings.

*“You should govern a large country as you would cook a small fish-lightly.”*

-Lao Tsu

***If you would like to receive a copy of our latest ADV Part II disclosure statement, please contact the office at 412-281-1948.***