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A March to Madness?

With our office in Chapel Hill, North Carolina, Hamilton Point has been immersed in what college basketball fans refer to as March Madness. As an investment advisory firm navigating a global financial crisis, recent times have caused March Madness to take on a much broader meaning. Some argue the United States has made great strides, while others worry our government is printing money and accumulating debt in a manner that will lead us deeper into trouble. That leaves us considering the likely impact of recent actions, and focused on investment opportunities we believe are best positioned to preserve capital and provide long-term returns.

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Our federal government has announced a $787 billion stimulus plan, which included over $180 billion for state governments, in hopes that jobs are maintained and that, magically it seems, money will be found two years from now to address growing fiscal imbalances. Never mind that some states didn't want these subsidized spending increases and were told that using it to pay down state debt in the interest of long-term flexibility was not an option.

Then the Treasury, continuing their focus on banks, unveiled the Public-Private Investment Program. Without delving into its details or recent announcements to "relax" mark-to-market accounting provisions, we simply say this ... while the attempt to partner with private investment funds was earnestly developed as a market solution, and did positively affect short-term perceptions, the fact remains that cash flows (or lack thereof) on trillions of troubled bank assets are *not* going to change under any of these programs. All that these programs alter is who stands to benefit to the upside and who assumes the risk of the downside. A hint: the government has made clear that the latter group will be the taxpayer under any scenario.

All told, annual federal deficits in the double-trillions for the foreseeable future are real possibilities. Since there is not enough money to fund such largess, the Federal Reserve has begun a process they euphemistically call "quantitative easing," or QE. Surely a naïve trying to guess what QE means would posit something like "gently pulling numbers out of somewhere"... and they would essentially be correct! What QE really means is that the Fed prints money to buy some of the very debt issued by other parts of the government.

EVERYONE GETS TO PLAY

The government plan is clearly focused on jobs, but will it accomplish the goal of a healthy *long-term* recovery? To expand on this, let's first be reminded that our "real economy" of consumers, businesses and nonprofit organizations are spending less, saving more and paying down their debts. This deleveraging of private balance sheets *will* continue by necessity. Since this process leads naturally to recession, it has caused unemployment increases of roughly 500,000-700,000 per month.

Some argue that with tough medicine, our state, local and federal governments should also contract along with the real economy. Unfortunately, a comparable 5% cut in government employment would mean another 1.1 million Americans out of work. So instead, government employment has risen slightly to 22.5 million, while the private sector has contracted by 5.2 million jobs in the last year. While keeping current unemployment as low as possible is the noblest of goals, the price ultimately paid—in the form of trillions in government debt—may outdo the ability of the now-shrunken real economy to provide sufficient taxable nutrition to the increasingly debt-laden public sector.

THE WHOLE WORLD IS WATCHING

The evidence of extant global imbalances abound. Japan and England have started their own QE programs. For its part China is suddenly concerned that the trillions in savings they lent to the USA may become devalued if the dollar falls. And gold, an investment that not long ago was held alongside cases of Campbell Soup and guns by those with survivalist tendencies, is becoming a mainstay allocation in institutional portfolios—including those managed at Hamilton Point, of course. (Kudos to survivalists, by the way!)

CALLING THE RIGHT PLAYS

While there is plenty *not* to like in the current global economy, and we can offer no guarantees, we do believe that Hamilton Point's fundamental research is leading us to some attractive values in the marketplace. The financial news will continue to be horrible for huge segments of the economy, but many fine companies have billions in cash—during a credit crunch mind you—and this spells opportunity. We are confident that our Global Core companies stand to gain through acquisition of ailing competitors and/or by using their financial strength to take market share from those distracted by debt problems. Worth mentioning as well is that our valuation work suggests substantial theoretical "cash-on-cash" returns[1] may be available to investors in these selected highly profitable blue chip stocks—even if earnings growth is nil for the foreseeable future.

Opportunities in fixed-income investments exist but must also be uncovered with extreme care. Given the potential for localized surprises, unreliable debt ratings, spurious insurance guarantees and basic cash flow problems with most state governments, investors should tread carefully when purchasing municipal bonds. However, there are opportunities to be selective in the municipal market which currently offer tax-free returns exceeding those of low-yielding Treasury bonds in many cases. We are also buying carefully-researched, investment-grade corporate bonds which sport equity-like return potential and the balance sheet protection of bonds.

POSITIONED TO WIN

At Hamilton Point, we acknowledge that policymakers face difficult choices in an attempt to guard against a deflationary spiral. However, we remain concerned that our government at all levels continues to favor policies that delay tough choices, lead to long-term inflationary pressures and ultimately prolong the period of uncertainty and volatility. We further caution investors to ignore much of the short-sighted "noise" in the media—be it cable news melodrama or hysteria over daily market swings—and instead stay focused on genuine indicators that will reveal when our economy may be recovering in a sustainable manner.

More than ever, we favor our investment model over that of the gigantic money management machines that are at a distinct disadvantage in this environment because their asset size prevents them from being selective. As America undergoes its current recession, we are working to steer client portfolios through the "Madness" and uncover the opportunities that are inevitably laid bare by such disruption.

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[1] (Net Income + Depreciation & Amortization - Capital Expenditures) / Market Equity Value