The CJ Investment Newsletter

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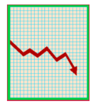
Misunderstanding Capitalism

Quick Look

Market	**Next Expected Move**
?	

	Month	**YTD**
DJI	3.97%	-1.54%
COMP	4.98%	3.15%
SPX	4.31%	0.60%
Gold	6.80%	9.95%

- In the US, we supposedly live in a capitalistic economic system. For many reasons, most of us, including the highly educated, fail to understand what that is and what it means. I hope to add a little perspective on this to my readers this month.
- After a significant market decline in January, the stock markets rallied in February. Some indices, notably the SPX and the COMP, touched new highs.
- The uncertainty abroad, especially in the Ukraine, have been whipping the markets around, creating positives for the USA as an investing safe haven, while roiling some other markets.
- Notably, gold was up in both January and February, and is up almost 10% YTD.

Review?

In the US, we live in a now heavily modified, but still basically capitalistic economic system. I suppose a purist may call it more of a socialistic/capitalistic mix. Regardless, it is just *inconceivable* to me (Alert to movie geeks: Remember *The Princess Bride*?) our failure, as a group, to actually realize what that means and how to deal with it. Judging by our inexorable shift towards socialism since at least WWII and probably since the progressive movement began in the early 1900's, we neither understand nor respect capitalism. Certainly our politicians don't, as a group.

Without going into a long diatribe (I hope), let's review a few of the basic concepts of capitalism.

While not all of the population needs to participate directly in a capitalistic system, two groups are absolutely necessary in order for capitalism to survive and thrive:

- Savers (capitalists)
- Entrepreneurs

My online *Merriam Webster Dictionary* defines the common meaning of the term capitalist, not the more important economic definition. Capitalists do not have to be rich, have investments *per se*, or be politically favorable towards capitalism. They don't even have to know what capitalism is; they merely need to be savers who seek to make a return on their savings. The *capital* in capitalism is merely savings. It all starts there.

That may mean savers (henceforth called *capitalists*) invest some or all of their savings in business ventures, or it may mean they simply put their savings (*capital*) in a bank to receive overnight interest or what used to be called passbook interest, now interest from certificates of deposit (CD's). The bank then acts as an agent in providing capital (savings) to entrepreneurs or existing businesses *through lending* for a return (*interest*) commensurate with the assessed risk taken on the capital.

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Interest is simply the cost of renting capital. Making a *profit* on the use of the capital allows for the repayment of the borrowed capital and the associated interest, as well as a *return* for the entrepreneur. The bank then pays the capitalists their agreed upon interest from the returns they make in lending the capital to entrepreneurs. Amounts in excess of the interest owed the capitalists become the bank's profits.

Entrepreneurs can perhaps be most simply defined as people with *actionable business ideas* that wish to start a new business or expand an existing business in which they can make a *profit*. *Making a profit is critical*. Without profits, businesses do not have the ability to pay back the capital they borrowed for the venture, nor the *interest (rental cost)* attached to borrowing that capital. Without profits, the entrepreneur cannot realize a personal return for his effort and risk taken. Without profits, the enterprise undertaken will eventually fail, destroying *capital* in the process.

While savings capital provides the foundation for capitalism, *profits* are what drive the expansion of a capitalistic economy and the benefits that come from that expansion. Savings alone would never allow the expansion of the economy and improvements in standards of living that savings and profits could. Additionally, without sufficient amounts of both capital and profits, capitalism as a system fails.

It's not germane to our discussion to deal with the concept of free economic transactions here, although that certainly is a crucial part of the entire theory. Economic competition is also crucial to understanding. Pursuing these concepts now would both distract from the overall message I'm trying to convey in this article and exceed the space I try to keep these letters from exceeding. Perhaps we could deal with that in another letter, when appropriate. If you are curious, please call me and I'll be happy to discuss these other ideas.

Finally, before resuming our discussion of how capitalism is misunderstood or simply not understood at all in the US, did you notice that the entire discussion above did not use nor discuss the word *money*? Although we have discussed this before in previous *CJ Newsletters*, it is crucial to our current discussion to understand that *capital* and *money* are different in our system now, although they don't have to be. *Capital is real wealth; something of value with an intrinsic use*. A classic example: a farmer's excess grain after a harvest is capital. *Excess* refers to the grain harvested that he will not keep to himself for future consumption. That excess constitutes capital (savings) which the farmer can then *trade* for other things that he and his family need.

Capitalism is not dependent upon money, although money, especially if it is *hard currency* (money of intrinsic wealth, such as gold or silver), makes the *trades* used in the capitalistic processes much, much more efficient. Its portability and divisibility provide much more precise and accurate measurements of value, which provide smoother, faster and fairer transactions involving both capital and profits.

Ramsey

For those of you who are Dave Ramsey fans, be patient with me. I have no intention of criticizing him heavily or calling him a charlatan. Nor do I think he is a genius or a savior. For some people who have previously been unable to keep their financial lives under control, some of his messages have probably helped them regain the control they needed. That is a good thing.

My purpose in referring to Ramsey here relates to how some of his policies reflect his misunderstanding of capitalism and what the potential impact his stated policies would have on our supposedly capitalistic system if they were universally adopted. He has a considerable following. We will examine whether some of his policies are helpful or harmful in the macro sense.

For those who wish a more micro (personal) view of Ramsey's investment policies, below is the web address of an article that describes (accurately I believe) the investment aspects of Ramsey's ministry, for lack of a better word. It brings perspectives to both the quality of his investment advice and to the man in general. Fair warning: this article IS highly critical of his stated investment policies. The address: http://badmoneyadvice.com/2009/05/ten-things-dave-ramsey-got-wrong.html

Ramsey makes a simple message in particular to his acolytes: *Get out of debt and stay out of debt*. I have neither heard nor read anything from him modifying his mantra *in any way whatsoever*. As far as I can tell, this is a black or white issue to Ramsey. If I am wrong about this, someone please correct me. Regardless of Ramsey, the following discussion is true if an absolute "no borrowing" policy is adopted by most people.

In light of our discussion above, what are the macro consequences of his advice, if it is adopted and obeyed

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by all, or even a significant amount, of our people?

To begin with, the savings part would be helpful in creating new capital. That's the good part.

But, if no one borrows for any reason whatsoever (his stated goal, not mine), we are faced with the following:

- To what use would all that saved capital be put? Without borrowing or lending, how would capital be allocated to entrepreneurs that create the new products and companies? That expand our economy and improve our standard of living?
- Without the returns generated to capitalists through the lending process, where would they get returns on their capital? If their capital doesn't generate returns, what happens to the incentive to save?
- What would happen to the real estate industry if all construction had to be paid for from savings without using borrowing? (Hint: crash)
- If no one borrows, where would banks generate the interest income from which they survive, pay their employees, shareholders and their depositors (capitalists)? (Same hint.)
- Where would the government be? What would happen to your taxes if the government actually adopted a "no borrowing" policy, even in the short-term? What would happen to taxes if they resolved to pay off ALL of the national debt?
- What happens to patients who need medical treatment to live and thrive that haven't saved enough to pay for it?

The short version? Capital is destroyed, capitalism collapses, business collapses, the government collapses and our society collapses. We learn to be Russian or Chinese. Maybe we should rethink that absolute "no borrowing" rule.

I have asthma. Until they create a cure, I will always have asthma. Until it's curable, I will be in a *management* situation as long as I live. The key to living as well as possible with a chronic disease or condition is responsible management. Refusing to manage my condition only leads to a less healthy life and premature death.

No borrowing will destroy capitalism. I explained why in the first section above. It is an integral part of distributing capital resources to those who can best use them. The key to solving the problems associated with borrowing is responsible management, not refusing to borrow entirely. Extremism is rarely beneficial.

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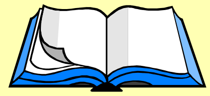

Recommended Reading

The next time you're thinking that government intervention is the solution to any problem and that equality of results is the overriding concern, think about the lyrics of this song from the Canadian band, Rush.

The Trees

There is unrest in the forest.
There is trouble with the trees.
For the Maples want more sunlight
and the Oaks ignore their pleas.

The trouble with the maples
(and they're quite convinced they're right),
they say the oaks are just too lofty
and they grab up all the light.
But the oaks can't help their feelings
if they like the way they're made
and they wonder why the maples
can't be happy in their shade.

There is trouble in the forest
and the creatures all have fled
as the maples scream 'Oppression!'
And the oaks, just shake their heads.

So the maples formed a union*
and demanded equal rights.
'The oaks are just too greedy.
We will make them give us light.'
Now there's no more oak oppression
for they passed a noble law
and the trees are all kept equal
by hatchet, axe, and saw.

*I think the context here is more of a political party, as opposed to a workers' union.

Considering that Canada is a socialist country, the poignant writing and recording of such a song by a Canadian band is amazing. Although he denies it, I believe Neil Peart's point is that limiting, damaging, and defiling the naturally "favored" oaks improves neither the maples nor the forest generally. You can't strengthen the weak(er) simply by destroying the strong.

From Sir Winston Churchill: *"The inherent vice of capitalism is the unequal sharing of blessings; the inherent virtue of socialism is the equal sharing of miseries."* Mandating equality of results rarely creates a richer or better system of any kind, especially political, but it surely seems to be able to buy votes.

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Yellen

From another part of the spectrum comes Janet Yellen, the new Chairwoman of the Fed. In her initial semi-annual Humphrey-Hawkins testimony to the House, she was asked by Shelley Moore Capito, a Representative from West Virginia, about the low current interest rates created by Fed policies (since about September of 2008). Specifically, her question dealt with how the artificially low rates were quite hard on savers and seniors relying on savings to live in their retirement years in her state. Yellen's answer absolutely astonished me.

According to Yellen, "…interest rates are low for a fundamental reason. And that is because, in the US and in the global economy as a whole, there is an excess of saving relative to the demand for those savings for investment purposes. So, the rates of return that savers can expect really depend on the health of the economy. And with a weak economy where there is a lot of saving and less demand for those savings, that's a fundamental drag on growth and on what savers can expect. Our objective in keeping interest rates low is to promote a stronger recovery and, in a stronger economy, savers will be able to earn a higher return because the economy will be able to generate it." Here's a link if you would like to hear the entire 1:47: http://finance.yahoo.com/video/yellen-interest-rates-low-fundamental-161300004.html.

Like many Keynesians and other economists that are slaves to their models, Yellen seems to be unable to see the forest for the trees. True leaders at the highest levels have to be able to leave the detail and get the big picture when needed.

Initially, she refers to the law of supply and demand being shifted by the economy's weakness creating an "excess of saving relative to demand." In what world is that possible? Interest rates were sky high (relatively) in both the Depression and in the "malaise" of the 1970's. Remember, interest charged to borrowers is a function of *both* available capital and of risk. In a recession, risk levels skyrocket, and, therefore, so should interest rates. It's also a bit hard to believe with extended unemployment experienced the last few years that there can be any "excess savings." Maybe for a few, but not for the group.

Her initial reference to the law of supply and demand does not refer to the Fed's ability to manipulate interest rates through money supply manipulation. This type of manipulation can counter the natural conditions of an economic phase, it seems, for much longer than I originally thought. But, she contradicts her own first argument when she says, "Our objective in keeping interest rates low…" (See the entire quote above.) In saying this, she admits that the Fed does have significant control over market interest rates and that the Fed is intentionally keeping interest rates low in order to stimulate the economy. Of course, it hasn't worked, other than to force money into the stock markets for the last 5 years it's been done.

She completely fails to address the much bigger issue caused by the Fed's meddling. *Low interest rates are a disincentive to savings*, as described in the first section of this article. So, where are the savings of capital going to come from if savers can't realize a reasonable return? Answer: they won't. Sadly, all the money the Fed creates does NOT create any capital. Capital is created through savings and profits. The Fed provides neither. She thinks the Fed is digging the economy out; it may be digging a grave instead.

Purpose

The *CJ* Investment Newsletter deals with most of the spectrum of securities investing, including cash (money market funds), bonds, equities and derivatives. It will evaluate the overall investing environment and, from time to time, discuss the relative allocations (including avoidance) of these asset types, as well as strategies to implement them (individual stocks or bonds, CEF's, ETF's, open-end mutual funds, and derivatives). Essentially, it reflects what I'm actually doing with my clients.

However, that's not its only purpose. Even if you never become a client, if you want this information, I want you to have it – for a while, anyway. My hope is that providing this information and teaching you what I consider important when investing may help you. I'd also love to hear any questions or comments you may have about my letter.

These letters are not sent "cold." Either I know you or someone you know gave me your name. Yes, this letter *is* a sales tool. It communicates how I analyze the markets and economy, as well as how I apply my investment strategies, so that you can decide, without any sales pressure, if my thinking is compatible with how you want your money invested. If you're not already a client, I would like to discuss your *becoming* a client. Please contact me for more information.