November 20, 2015

DR. BEN BERNANKE

Dear Investor:

As you may know from talking with me recently, Dr. Ben Bernanke was the keynote speaker at this year's National Conference put on by Commonwealth. I would like to share with you his thoughts and opinions on some of the economic issues of our time. My overall impression is that he's a very intelligent and articulate person. He basically seemed like a pretty decent guy and very bright. It's not my intention to get into the differing opinions on what caused the crisis or what solutions were available at the time. I just want to summarize some of the things he discussed with us. I hope you find it informative.

His opening comments had to do with the crisis and what happened in 2008 and 2009. Leading up to that time, Dr. Bernanke stated they were aware of the fact that housing prices were quite high. They were not aware that subprime mortgages would begin to collapse and trigger a panic. Things had started to go bad earlier in 2008, but everything came to a head at what he called "Lehman Weekend". Hank Paulson and Tim Geithner had tried their best to find a merger partner for Lehman Brothers, but no one wanted it and Lehman filed for bankruptcy. Then AIG was also on the ropes due to insuring large blocks of subprime loans that were going bad. AIG was actually a lot bigger than Lehman with huge counterparty risk all over the world. It was the world's largest insurance company at that time, but no private investors were interested. Bernanke did not think the financial system would be able to handle an AIG bankruptcy. Markets were already on the verge of panic, and he said if AIG had collapsed, it would have been "cardiac arrest" for the system. They presented this to President George W. Bush. After listening carefully, he told them to do what they had to do. After presenting the facts to leaders in Congress, Harry Reid told them they were on their own and Congress would not accept any responsibility. What followed the next morning was an $85 billion loan to try and keep AIG alive. He made it clear that he did not see any other alternatives and believed they had to lend the money to AIG to prevent the system from completely collapsing. He believed the Fed had to act quickly and decisively and that Congress was paralyzed.

We know there were several other substantial measures taken to keep the system from collapsing. One of the most well-known was the TARP program. This was created and run by the Treasury to purchase assets the market didn't want at that time. The purpose was to inject liquidity into the market. The TARP has also been credited with saving the US auto industry which is currently booming. We also remember that the Fed opened the discount window after cutting rates and basically encouraged banks to borrow what they needed to shore up their cash. Then there was the grandad of them all which is the quantitative easing, or QE, that we have been living with for several years now. The sum total of all these efforts appear to have kept the US from sinking into a major depression. If the liquidity in the banking system had completely shut down for a period of time (which was already beginning to happen), the economy would have taken a huge hit. People would have been unable to access any significant cash from their banks or ATM's, and their confidence would have been shattered. Perhaps we would have had to line up at the banks to withdraw a few hundred dollars per day, as we recently saw happen in Greece. This is the "cardiac arrest" that we avoided, and for the record, Ben said that all the money from TARP has come back to the government with interest.

Moving on to the present, we are now at the point where the QE purchases have stopped. You probably remember the "taper" as these purchases slowly decreased over a period of time. The next move, which has been talked about for at least a year now, is to slowly begin raising rates to more normal levels. Dr. Bernanke believes the US economy is doing fairly well right now. Here are some of the positives he mentioned: the US is a good place to invest; our demographics are good; we are still the tops in tech in Silicon Valley; we have a good long term outlook; and we have a flexible economy. He says the main drags are outside the US right now. The risk is, can our domestic economy overcome the drags? Our own growth has been modest. We have low forward momentum, which adds to downside risk. We have political paralysis, our leaders are not working well across the aisle. We also have geopolitical risks which cannot be predicted. He does believe that the US economy is the strongest in the world right now, and that is the main reason for the strong dollar. He states that the question for the Fed is "Do we have enough overall momentum to absorb rate increases?" That is the judgment the Fed has to make. He mentioned momentum several times as being very important. He doesn't want to see the forward progress of the economy stall out. He said he does think we can overcome the headwinds, but we have to think, what are the risks of an adverse outcome? His comments throughout the talk made it very clear he thinks in terms of risks, and the probabilities of different outcomes. It was very clear to me he understands what goes on in the real world. He also discussed the fact that the Federal Reserve District Banks have boards that are made up of private business people. Overall, the Fed has a lot of contact with the business community. They are not isolated from what's happening on Main Street.

He made some direct comments that relate to us as investors. He said investors need to understand and accept that we are in a low return environment at this point in time. He recommends that investors do not try to overcompensate for this by raising their level of risk. He stressed, don't overreact to short term data, and manage your investments for the medium to long term. Try to shut out the noise and keep your eye in the ball. He said Janet Yellen has to work within the world we are living in, and that is a low return environment. His comments on risk are very important to us. It is not a good idea to follow some who have continued to stretch for more return than what is available on high quality investments. We all know things change and sometimes they can change fast. At that point, there will be people who will wish they had stuck to their original plan, as they experience larger losses than they are comfortable with.

The things that have happened in the US economy the last ten years will be the subject of history books and debate for a long time to come. After hearing Dr. Bernanke, I'm convinced of his sincerity. The key to understanding his policy decisions is the academic work he has done on the US depression of the 1930's. His study of that history convinced him that much of the depression was caused because the Federal Reserve was passive and failed to act aggressively to fight deflation. The result was 25 percent unemployment and several million people losing their life savings as over 9,000 banks failed. (There was no FDIC at that time). I've read quite a bit on the depression and I can tell you the suffering was intense. He did not want to make the same mistake. The decisions that were made in the recent crisis were the best judgments of the major players at the time. They did what they could to keep the system going. We cannot know with certainty what other outcomes might have looked like. The economy has clearly moved forward the last seven years, but we are still in uncharted territory. It's unclear how this will all turn out. Right now it appears that things will work out. Our best hope, in my opinion, is to get back to a world where the price of money (what we call interest) is set by the market. We also need to see the large buildup of assets on the Fed balance sheet runoff and return to the private marketplace. This could take many more years if it happens at all. Overall, it was a very interesting talk and time well spent.

Best Regards,

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