The Quarterly Report

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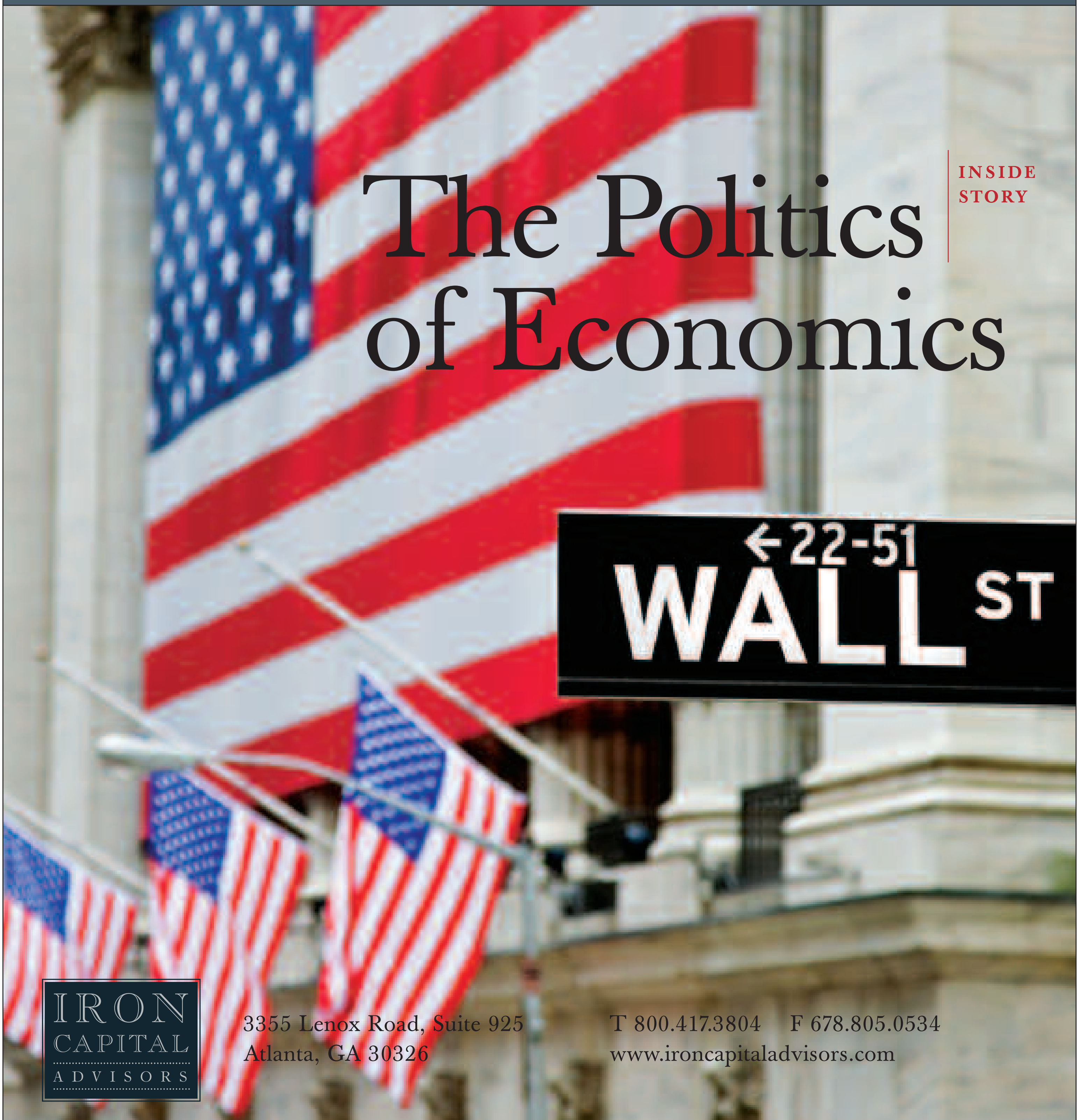

The Politics of Economics

INSIDE STORY

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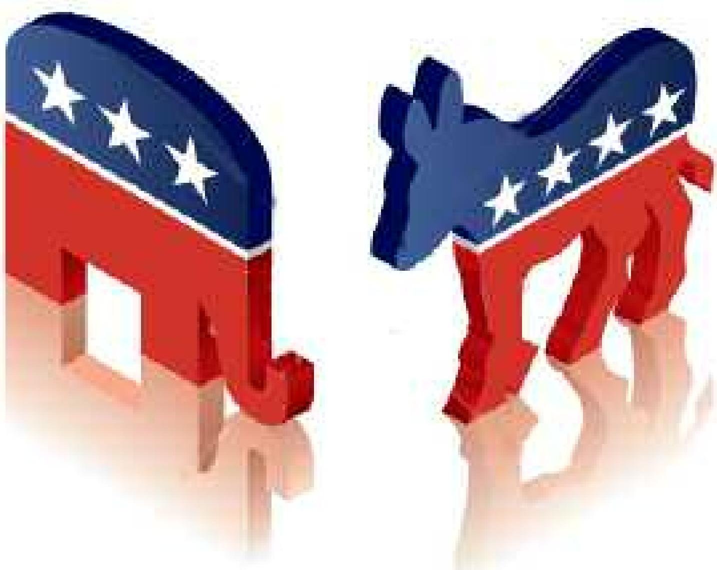
The Politics *of*



We are thankfully coming to the end of what has been the longest, and in my opinion the least substantive, presidential race in American history. Oh, we all know who the latest internet poll says is winning, but can anyone accurately describe either candidate's platform? On August 25 of this year the *Wall Street Journal* reported on a Pew Research poll which recently discovered that, for the first time, more than 50% of Americans knew that the Democrats have been in control of Congress. If our media have failed to relay this basic fact to the American people, how well do you think they have done in educating people on the nuances of the candidates' economic policies?

Okay, I know what you are thinking, is Chuck actually going to talk about politics? We try to avoid such subjects at Iron Capital, as we advise clients of all political persuasions and of course do not want to offend anyone. However, in the midst of what may be the worst financial crisis in our country's history, we think we owe it to our clients to weigh in on economic policy. After all, it has a direct impact on your wallet and is our area of expertise. I make you two promises during this foray into politics: I will stick to economics, and to avoid showing favoritism, I will make sure that I offend everybody.

I will begin the offending process by stating a disturbing fact to the most partisan. While there are plenty of subjects for Democrats and Republicans to disagree on, the basic framework of economic policy should not be one of them.

Earlier this year, the University of Chicago launched a $200 million academic enterprise called the Milton Friedman Institute, named after the famous economist and Nobel laureate who spent the bulk of his career on staff at the school. The effort was attacked by many on the faculty in other departments, most notably by Bruce Lincoln, a professor of the history of religion. The reason for the backlash was a statement made by the institute that it would "reflect the traditions of the Chicago School and typify some of Milton Friedman's most interesting academic work, including his…advocacy for market alternatives to ill-conceived policy initiatives."

Professor Lincoln is upset that the University of Chicago could make such a statement as if it has been *proven* that the free market is superior to government intervention. After all, the battle between free market capitalism and socialism / communism constituted much of 20th-century politics. Lincoln seems surprised to learn that this argument is over. Evidently there has been some confusion as to why Friedman won the Nobel Prize.

Milton Friedman won the Nobel Prize in 1976 because he and his esteemed colleagues from the University of Chicago (from which there have been 25 Nobel Prize winners in economics) transformed economics from a soft social science to positive science. They introduced quantitative analysis of their theories. Friedman defined the Chicago School of Economics as "an approach that insists on the empirical testing of theoretical generalizations and that rejects alike facts without theory and theory without facts." Friedman actually believed in government intervention in the economy, until the empirical evidence from his research proved otherwise.

What Friedman learned, which surprised him, was that the less involved the government was, the freer the market, and the better off the society as a whole. Particularly surprising, and something that still goes against conventional wisdom, was the fact that the middle class in particular was better off

Economics

in a free market. In fact, the middle class is a free market phenomenon. The more government is involved, the more you have only two classes of people – the ruling elite and everyone else. This is not an opinion, it is empirical truth. Once you have sailed *around* the world, arguing that it is flat doesn't make sense.

Now this is when my Democrat friends will tell me that I'm just spewing Republican propaganda and if any of this is true, then how do you explain this crisis?

When Democrats blame "Bush's failed policies" for the current crisis, they often follow it up by the political stereotype of Republicans. They say Bush was in love with the free market and deregulation. They fail to remember the lesson that can be found in one of my favorite political movies, *Charlie Wilson's War*. Joanne Herring, the socialite played by Julia Roberts, asked Charlie why Congress was busy saying one thing while doing nothing, to which Charlie responded, "Well, tradition mostly." When it comes to politicians, it is a good idea to take the advice often given to young girls about boys: pay attention to what they do, not what they say.

The problem with the argument that deregulation caused this crisis is that there has not been one act of deregulation in the entire eight years Bush has been in office. The fact is that Bill Clinton, whose political stereotype would be of a pro-government regulator, actually reduced the size of government and passed significant *de*regulation. As a result the economy grew under his watch and most Americans prospered. The only regulatory accomplishment of the Bush administration has been Sarbanes-Oxley, which has no direct relation to our current problems, but was arguably the single largest increase in regulation since the Great Depression. This crisis has been caused by Bush's failed policies, but those policies have been to grow government and increase regulation.

Once government interference starts, it is like being on a drug. It makes you feel good at first, but then the crash occurs. A rational mind would say, "I must get off this drug because it makes me feel so bad," but that isn't what the drug addict thinks. He thinks he needs even more, and the destructive cycle begins. You regulate an industry, so they become incented to get friendly politicians elected. The industry contributes large sums to campaigns, and politicians rig regulation to help their financial backers. While some regulation is obviously needed, we must remain mindful that regulation often leads to corruption.

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REVIEW *of* ECONOMY

PESSIMISM HAS TURNED TO SHEER PANIC in the economic talk. The financial crisis has dominated all the talk as the short-term credit markets practically stopped working during the quarter. Every previous financial crisis in US history had been caused by an economic slow down. This crisis however seems to have caused itself. With all the bad news the economy remains surprisingly resilient.

GDP growth for the 2nd quarter 2008 was 3.3%. Much of that was due to the stimulus checks, and exports but that is solid growth under any circumstances.

Unemployment has risen to 6.1% in September. The employment picture is getting worse as there are few new jobs being created. Even with positive growth the economy certainly feels like it is in a recession.

The financial crisis of course dominated the news, and it has led to dramatic governmental intervention into the markets. The controversial bailout package is a necessary evil. The ramifications of the financial system collapsing would be dire. There is not a single job in this country today that does not rely on a sound and functioning financial system in order to exist. Whether or not the entire system would have failed we will never know, but it was uncomfortably close to happening. I believe that we should all be glad that we will never have to find out. +

REVIEW *of* MARKET

IT WAS A BAD QUARTER, as most of you are already painfully aware. So I won't belabor the point.

The S&P 500 ended down 8.37 % for the quarter. Small caps did outperform, as we had predicted. The Russell 2000 Value index was up, yes I said up, 4.96%. The Lehman Brothers U.S. Aggregate Bond index was down 0.48% as the credit crisis worsened. Interestingly, actual defaults remain low. This crisis is a crisis of confidence not entirely based in reality.

International markets simply got destroyed as the MSCI EAFE was down 20.50%. Emerging markets did even worse declining 26.86%. +

MARKET *forecast*

PERHAPS WARREN BUFFETT'S MOST FAMOUS QUOTE IS "Be greedy when others are fearful and fearful when others are greedy." You will not see much more fear than is out there right now. It is time to be greedy. Mr. Buffett is certainly taking his own advice, with some well publicized investments of late. We believe you should do the same. It is time to buy.

USA, USA, USA! American stocks are the cheapest they have been in 20 years. After several years of underperformance relative to the rest of the world we believe the U.S. is once again the place to be invested. We are currently neutral on growth vs. value. We have small caps at a neutral weighting as well.

We have been right about international stocks coming back and perhaps should have been more aggressive. The global economy is slowing, and the credit crisis is creating a move towards quality.

We believe the opportunities in bonds have shifted to the corporate and high yield bond market where differential between spreads and default rates is still growing. +

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Like Democracy, *capitalism is not perfect, but it is the best system we have.*

This same cycle is evident in what has really happened in our current crisis. The federal government many years ago made encouragement of home ownership national policy. They created Freddie Mac and Fannie Mae to back mortgages made to lower-and middle-class Americans. This worked great at first, as more and more Americans were able to buy homes. Then these government agencies started donating hundreds of thousands of dollars to the very politicians who were supposed to be policing them. In return for their generous gifts, there was more and more encouragement of creating mortgages for anyone who wanted one, whether they could qualify or not.

This created a distortion in the free market. The perceived risk of lending to so-called subprime home buyers was reduced because of the inherent government backing – banks knew they would be bailed out if it went wrong, so why not do it. This was only compounded by the evolution of securitization, which allowed banks to sell their mortgages in bundles to further reduce the risk.

Bubbles occur when markets get distorted, and when a bubble explodes, we have a crisis. This crisis was caused primarily by the drug of government interference in the marketplace, which led to corruption. The rational solution would be less government involvement in the mortgage market, and better, not more, regulatory oversight. However, the knee-jerk reaction is simply more regulation, which will once again make us feel better in the short-term, but will lead only to misery down the road.

We have a very important choice to make when we go to the polls in November. It will determine in a large part whether we do the wise thing in response to this crisis, or do the emotional thing and make things worse. Milton Friedman and his fellow economists have proved that the empirical evidence for free market capitalism is overwhelming. Like Democracy, capitalism is not perfect, but it is the best system we have. Crises like the one we are in now are almost always caused not by truly free markets but by market distortions caused by government involvement.

So which candidate understands this, and would be better economically? The only advice we can give is to vote how your heart leads you, but do so not based on what politicians say in their speeches, but based on what they have actually done in their careers. Remember the "Liberal Democrat" Bill Clinton reduced government, balanced the budget and gave us eight years of economic growth, while the "Conservative Republican" George W. Bush has grown government, increased regulation, and given us the worst economic crisis in generations. If the economy is your issue, vote for the candidate who has a track record of actually trying to reduce government and create better, not more, regulation. Remember Charlie Wilson's warning. Saying one thing and doing another is a tradition in Washington. Don't pay attention to speeches, pay attention to what candidates have actually done.

Chuck Osborne

CHUCK OSBORNE, CFA, *Managing Director*