Understanding Modern Portfolio Theory in a Political Economy

The Solari Report
by Catherine Austin-Fitts

December 18th, 2008

Welcome to The Solari Report. Today is Thursday, December 18th, 2008, and I am Catherine Austin-Fitts, and I am delighted you could join us this evening.

Our first segment is tonight is going to be Money and Markets, where we discuss traditional or modern portfolio theory and its application under current market conditions, and then we are going to move to Ask Catherine and respond to a subscribers question about the amount of US debt outstanding. For Movers and Shakers, we are delighted that we are going be joined by investigative reporter Jon Rapapport, and then that will be followed by the Let's Go to the Movies segment, and this week it is one of my all-time favorites, as anybody who knows me knows, Enemy of State with Will Smith and Gene Hackman.

So let us dive right into Money and Markets.

Modern portfolio theory, or what I sometimes call traditional portfolio theory. What is it? It is many things if you really want to dive into all the analytics and the academic part of it, but essentially what modern portfolio theory says is that an investor can use diversification to reduce risk, and by doing so can optimize portfolio performance through different cycles in the economy. And the idea is to invest in a broadly diversified portfolio of assets, and that way the performance of class of one class will differ from the performance from others. And you are looking for asset classes that are counter-cyclical which are not correlated to each other. So, for example when information/technology stocks are up, maybe utility stocks are not doing so well. And when utilities are doing well, then the internet and technology stocks are [down] is kind of the gist of it. This idea of diversification also leads to another recommendation which says do not try to time markets, do not try to get in and out of things, and just stay in this broad diversified group of assets and live through the cycles, the ups and downs of the business cycle. So, the economy goes down and it goes up and you just stay in through the cycles.

Now, this theory has been used over the last year or two to persuade investors that they should stay in the stock market and the financial markets and that they should leave their retirement savings invested in the stocks and bonds or large financial institutions because that is part of a diversified group of categories. Now, I believe that modern portfolio management is a very useful tool, however, the current application leaves a great deal to be desired. And I want to go through that tonight and tie that back to the stories that we have been posting on the blog in Money and Markets.

First, let us talk about diversification.

Real diversification is a great thing. The reality though is that most corporate stocks and bonds, particularly that a US investor is buying, are not truly diversified in the way that they might have been 20 or 30 years ago. If you dig into the financials of many large corporations, and certainly now many large banks, what you find is that these are companies that are deeply dependent on federal government purchases, on federal government contracts, and now more federal government bail outs. And so, in fact, they are not in different industries, they are very much a credit of the US government, and the US government's ability to borrow more money. And so the issue of how much debt the US really has

outstanding is very pertinent to an analysis of how strong these companies are because they are so dependent on the government being able to borrow more money. Now that is corporations. Let's look at state and local government and we are going to find the same thing. What you will find when you dig into the financial statements and the balance sheets of many counties and towns, and certainly state governments, their finances are very intertwined with the federal government, and again, deeply dependent on the federal government's ability to borrow more money. And then another category in many portfolios in addition to corporate stocks and municipal bonds is bank CDs, or other paper from financial institutions, which again are dependent on FDIC insurance, and significant provisionel of loans from both The Treasury and The Federal Reserve. And then finally, of course, you have agency in treasuries and social securities. So it is not unusual for me to look at a portfolio and look at has through the mutual funds thousands and thousands of corporate stocks and bonds, municipal bonds, bank CDs and other bank securities, and federal agency and treasury securities. And what I am looking in at with all those thousands of stocks and bonds, is essentially one security, and that is the credit worthiness of the US Treasury to be able to borrow more money and The Federal Reserve to print more money.

And so, it is not diversification.

So if we are going to apply modern portfolio theory to your portfolio, what we need to think about is how do we achieve true diversification, particularly when we look under the rug. And so the moral of the story is diversification is a wonderful thing, but in a world where the economy has become this centralized – how do you achieve real diversification?

So that is issue number one.

The second issue that really informs the application of modern portfolio theory is the question: Is the market a market, or is it an economic warfare battle zone? You have heard me say last week, and certainly on all the radio shows and events that I do, saying, the stock market is no longer a market, it has become an economic warfare battle zone. So, let me give you some reasons why I believe this.

First, we have over the last decade the government and the central bank intervening - not just in the US, but throughout G-8 – in the markets in extraordinary and dramatic ways. Not just in the bond markets, but in the currency markets, in the stock markets, and this is becoming more and more overt. And certainly with the bailouts, it has become extremely overt. The process means that different large financial institutions are acting as the agent for the government. I mean, the government needs somebody who can execute these interventions. And so we see, for example, the emergence of a group of banks in New York, who are New York Fed member banks, who are literally in the market and have access to extraordinary inside information because they are trading on behalf of the, for example, The Exchange Trade Stabilization Fund, which is in essence a slush fund managed by The New York Fed, for the benefit of The Secretary of the Treasury, and reporting to The Secretary of the Treasury. This means that you have a group of insiders who have extraordinary inside information that the rest don't have and who are operating with the benefit of treasury and central bank support. So when they lose money, there is a bail out waiting for them, but when we lose money as investors, there is no bailout waiting for us. And this is a situation of highly managed markets, not markets in the sense contemplated by traditional portfolio theory. So, issue number one - government and central bank intervention.

Two, and perhaps even more important, we are looking at extraordinary levels of fraud. If you haven't looked at the posts on our blog about naked short selling (see www.businessjive.com), I recommend them to you. But essentially, naked short selling is a process where the large players in the financial system can draw down the value of the smaller companies in any sector in a way that has nothing to do with their performance. It is flat out economic warfare. It is fraud that makes money for the fraudsters and harms

the really productive parts of the economy. And that has been permitted to happen. We see that naked short selling is one of many examples, but we see the absence of significant enforcement. If you got on the call earlier, you heard Jon and I talking about the Bernard Madoff story. We have an old line family firm in New York that now announced that they have lost $50 billion dollars in a running ponzi scheme for, say, almost two decades. That could not happen without institutional support at high levels and with the enforcement agencies standing down. In the notion that one head of a firm can run a double set of books on an operation that complicated for that long is absurd. So, we have a pattern of absence of enforcement.

Debt Overhang.

I was sitting several weeks ago in Estonia while I was having lunch with some money mangers from Munich, in Talen, which is the capital of Estonia, and they said to me, "Oh, you know the shakeouts are over. There are incredible opportunities in the equity markets because the price of all the equity on the planet is very much related to how much the debt overhand is." And they said, "don't you agree with us?" And I said, "Absolutely not. I think the shake out has just begun. The debt overhang is much greater than anyone knows." Then I proceeded to go through my different writings on mortgage fraud and why I believe that there is significant collateral fraud in both the treasury security market in the government mortgage market, and then the straight mortgage market, including Fannie and Freddie. And then they turned white and said that they were heading back to Germany and Latvia to redo their charts. So that with this level of fraud you are looking at a world of, again, economic warfare, and not markets contemplated by modern portfolio theory. Modern portfolio theory assumes a certain level of integrity in within the market.

Now, one of the things that most concerns me is that a lot of this kind of fraud is going to be used as a justification that we need more regulation. It is true in some areas that we could use some changes in regulations. We could use the ability to enforce and regulate derivatives. Bringing down Glass-Steigall was a terrible idea, and it would pay to bring it back up. However, the problem of the last ten or twenty years has not been that we did not have the laws on the books – it was the enforcement was selective. So, as I have written for example in Dillon Reed and the Aristocracy of Stock Profits, enforcement was used to drive the honest people out, and to help engineer the housing bubble. Or in naked short selling, we have seen an incredible stand down of enforcement. In the suppression of the gold market, it is the same thing, an incredible stand down of enforcement. We have certainly seen an across the board in industry after industry, a failure to enforce anti-trust. So the laws have been on the books, and enforcement has been used in select ways that support the centralization of the economy giving the people who are centralizing the economy. More power and more regulation is not necessarily going to change anything. It could make things worse.

So, the bottom line is with the absence of these basic standards, the question is: Is an economic warfare battle ground an appropriate place for retirement savings during a shake out?

Now, there are two other points I just want to touch on. One is that several years ago Warren Buffett was gripping about derivatives, and said something to the effect of 'derivatives are the financial equivalent of weapons of mass destruction.' What I have learned in talking with people about that comment is that many people do not fully understand the magnitude of what Buffett was saying. ...because one thing to understand about the derivative market is that it is unbelievably centralized here in this country among a small group of the New York Fed member banks, so JP Morgan, Chase, City Bank. So, it is several very large portfolios at a few banks. My theory, again, is that they are acting as an agent for the exchange traded stabilization fund and the government, and so exactly who bears the liabilities is not particularly clear. But what Buffett was saying was this, or what I want you to think about is this:

If I am the president of a company, a company that possibly is some of the people on this call are investing in, and I have stock, so I have equity which represents ownership in the economic value of my company, the value of my stock in today's market is not determined by what a financial course in a business school will teach you, which is the present value of your future cash flows. Instead, it is determined by the supply and demand for capital as it is determined by five derivative portfolios that I have no influence on, I can't control, and the government does not regulate. So, five players can put together derivative portfolios which can completely control and determine my price – the price of my equity and my ability to raise capital, and even the success or the survival of my company - in a way that is completely outside of my control. Which means that five banks can essentially drop a nuclear bomb on almost every company in the economy, and there is nothing those companies can do. And that means we have…created a level of risk controlled by a tiny few players that can literally bomb the whole market and determine prices across the board. So, the existence of the derivative market as it is currently constructed takes modern portfolio theory and just throws it out the window, because, again, we are in an environment that was never contemplated by that.

Finally, I just want to say briefly that there is a difference between a business cycle and financial coup d'tat. And what I believe we are going through is a fundamental re-engineering of governance and ownership of assets on planet Earth. Not just in The United States, but it has been going on around the world. We are going to talk a lot more about that next week. And so this is not a traditional business cycle – this is something else. And staying in the market in this kind of environment when it is not a cycle, but it is something else, it has a whole level of risk never contemplated by modern portfolio theory.

Now, let us just turn to couple different stories on the blog that really bear on this. I wrote earlier this year about the Dodge and Cox losses on Fannie Mae. Dodge and Cox is a *very* respected San Francisco money manager and when Fannie Mae and Freddie Mac and the mortgage market crashed they did a significant analysis of what was going on and took a position of over a billion dollars. They bought into Fannie Mae as the stock dropped and then absolutely got slaughtered when the government took over Fannie Mae and lost about a billion dollars. Now, the thing that is amazing about this is that this says is that Dodge and Cox really had no idea, despite all their intelligence and all their research about the level of fraud in the mortgage market and in the world of government right now in Washington – that they were naïve about what was going on.

Another big story over the last week has been about the broken strategy, about the fall of Bill Miller. And it is about Bill Miller who until a year ago was one of the most successful value investors. Very similar story to Dodge and Cox – as the financials dropped he bought in thinking we are at the bottom – did not even begin to understand the amount of fraud in the mortgage system or the debt overhang, and who is down 58% as of the writing of the story. So both times you have examples of very capable, very astute, very hard-working, very responsible investors who have been absolutely taken by surprise by the level of fraud. Now, one of the interesting things about these stories is our opportunity… (I talk a lot about this *The Positioning Your Assets* audio seminar)…one of the great opportunities over the next decade or two are companies and places – because it is going to be both communities and companies that offer real solutions to the financial issues and economic issues that need to be addressed and that we face. And flowing capital and attention and support to those efforts is not going to happen until a broad section of the people who are interested in finance and money and the allocation of investment in the society start to understand the real problems. And my hope of what could come out of the Bill Millers and Dodge and Coxes - understanding the real problems - is that we could start to see some very significant talent in the financial community start to understand what the real problems are, and so see the real solutions, and start to flow time, attention, and capital to those sectors, and if that could happen, there could be some lemonade in the lemon of Bill Millers 58% losses.

So, that is it on money and markets for this week. ...if you have people in your life who are telling you that traditional portfolio theory applies, I would love for you to digest this again (we are going to post the MP3 on your subscriber panel...) and I want you to really think about explaining to them that modern portfolio theory is a thing of beauty, but not it does not apply, because the assumptions that it is predicated on are very different than what we are watching in the world today.

OK. Ask Catherine.

We had a subscriber that asked a question that is near and dear to my heart. "How much US debt is really outstanding?" And let me just read you what he said. He said "Financial expert Max Keiser discussing the bailout on Al Jazerra says that the US has some $500 trillion in non-collateralized bonds - others argue that there is 1.5 quadrillion in derivatives trading contracts outstanding. Just how much debt is outstanding and what effect will this have on the global markets and the price of gold and silver despite central bank manipulation, and how do we actually know how much debt there is?"

Well, here's the truth: no one knows. The federal government for 13 years now has been required by law to produce audited financial statements and it has not done it. So, we know that Paul O'Neil, when he was Secretary of the Treasury, made an effort to produce a study to show how much debt was outstanding. They put it up on the web, they took it down right away. Then the next thing you know is that Paul O'Neil and the National Economic Advisor were fired. So, the truth is that we really do not know. What I believe is that the debt levels of treasury securities, government agency securities, or positions that the government is liable for, including whatever trading has been done on their behalf by the New York Fed member banks for the trade stabilization funds or any other aspect of the financial implementation of national security, is many multiples of what is in the official balance sheets. If you read my story, Dillon Reed and the Aristocracy of Stock Profits at www.dunwalke.com (you can link from my homepage) or my article, The Myth of the Rule of Law, I get into the details of why I believe that the collateral fraud in the mortgage markets is significant. If you look at our Missing Money page for all the money missing from the federal government at various times, it will touch on why I also think the same goes for treasury securities. So when Max says that there may be trillions or quadrillions of debt or derivatives that have been issued off balance sheet - which the government is liable for – what I would tell you is - that is absolutely possible.

The story this week that has really caught my attention, both last week and this week, is The Bloomberg versus The Fed. Bloomberg which has done some of the best financial reporting on the bailouts, tried to get The Fed to disclose the collateral that they were taking for two trillion, let me say that again, *two trillion dollars of loans*. If you want to know where the real bailout action is, it is not at The Treasury, which is only 700 billion, it is at The Fed, which now is in the many trillions. So Bloomberg submitted a FOIA to The Federal Reserve (a FOIA is a Freedom of Information Act request) asking for disclosure of what was the collateral that The Fed was taking. And The Fed has refused to disclose it. And so now Bloomberg has filed a motion in support of their FOIA to try to force The Fed to disclose what collateral. My theory on what is happening is that The Fed can not possibly disclose what the collateral is because The Fed can not possibly afford the market to know that the kind of collateral we are taking is full of collateral fraud, if anything the collateral may be nonexistent. So, The Fed cannot afford for the system to understand how bad it is. And so...if all of us were at The Fed tomorrow and we disclosed what was really going on, for all of those who know my red button story, that would really push the red button. And that is important, because one other thing The Fed is grappling with is the fact that the inter-banking market has ceased up because nobody trusts each other. So the more you disclose how extensive the fraud, and again, what I believe is it is far more extensive than most players really understand or know, but the more it discloses how extensive it is the more dangerous it is that the market is going to cease up.

Now, the solution to The Feds problem in disclosure gets us to another very top story this week, and that is The Fed has cut interest rates on Fed funds to a historic low of zero to a quarter of one percent. So, now they do not have to disclose collateral because the banks can just come in and get as much money as they want for zero percent. Now, what all of this means with this much debt outstanding is that the pressure on the current government officials to inflate their way out of the debt problem is going to continue and it is going to result in a real premium being placed on controlling and owning real assets. So, when you think about diversification in your portfolio you really want to think about real assets and where the real assets and the networks that can make a real difference to you.