

The Contrary Investor

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Forces of Nature (Revisited)

In December 2004, Fraser Management was asked to write an article for Business Week magazine. The article was included in the January 2005 edition of *Ruminations of the Contrary Investor*, titled Forces of Nature in the Investment Process.

Our premise in the article was that the number of storms and the resulting damage the U.S. experienced in 2004 would be norm, rather than the exception, for decades to come. “If one looks at these phenomena as the new “normal” order, rather than a one-time aberration, what trends might result? How can an investor position assets to participate where others might not? One answer might be a fundamental change in the interest rate environment for our financial markets. Consider the impact of significantly more storms and dramatically cooler temperatures on interest rates from two distinct perspectives – insurance companies and governmental entities.

Insurance claims for damage to private property from the storms of 2004 have topped \$20 billion. As a result, insurance companies will undoubtedly raise premiums, but in the meantime, they will need to sell large portions of their bond portfolios to pay these claims. A significant increase in the supply of bonds hitting the market will drive down bond prices and pressure interest rates upward. Insurance companies hold a very large percentage of the outstanding U.S. corporate bond supply, so their increase in selling of bonds will have meaningful impact on the interest rate environment. Similarly, the damage to the nation’s infrastructure (roads, bridges, etc.) and federal disaster aid is estimated at an additional

\$20 billion. Municipal agencies must have funding to repair the infrastructure, which means issuance of additional bonds. As more bonds are issued, the agencies must price the bonds attractively, meaning ever-increasing pressure to offer higher rates of interest. Federal disaster funding will result in increased budget deficits, which also moves interest rates higher.

So we now have forces in place which might last for decades that indicate a longer-term trend of higher interest rates.”



The September 9, 2005 edition of The Wall Street Journal.com featured an article that addressed this very issue. The following is taken from the article:

“As the \$2.1 trillion municipal-bond market grapples with the uncertainties wrought by Hurricane Katrina, one of its most immediate concerns is that one of its largest investor groups could unleash a flood of selling.

Mulling problems such as bond defaults, credit downgrades and the rebuilding of devastated areas -- particularly New Orleans -- traders in the market worry that property and casualty insurers may have to sell municipal bonds to fund claims against them.

"Munis could become an underperforming asset class over the next couple of months," said Gary Pollack, head of fixed-income trading at Deutsche Bank Private Wealth Management.

Given the devastation throughout the states of Louisiana, Mississippi and Alabama caused by the storm hitting the Gulf Coast on Aug. 29, there has been speculation about what parts of the municipal market -- ground zero for state and local financing -- might be most at risk.

Moody's Investors Service said yesterday that the fallout from Katrina could lead it to downgrade nearly \$6 billion in debt issued by the states of Mississippi and Louisiana. It placed much smaller amounts of bonds issued by the Jefferson Parish Sales Tax District and by the Louisiana Stadium and Exposition District on a possible-downgrade course. In all, Moody's placed the ratings of 51 credits in the two states on watch for downgrades, affecting about \$9.4 billion of bonds.

Market participants are watching for a possible slowdown in buying or acceleration in selling by insurers.

Property and casualty companies, such as State Farm Mutual Group or Allstate Corp.'s Allstate Insurance Co. unit, insure homeowners and commercial properties against loss. They held \$260 billion of tax-exempt bonds at the end of the first quarter, according to Federal Reserve flow-of-funds data released in June. Traders have been watching for indications that the insurers might be unloading, although they agree it is too early to know the extent of their losses, much less have claims in hand on which they have to pay. Still, a ripple ran through the market yesterday when a small institution, said to be a title-insurance company, tried to sell a few million dollars of New Orleans-related bonds.

Selling by property and casualty companies could pressure the market, especially in the 5 to 15 year area, where the purchases are concentrated, Mr. Pollack said.

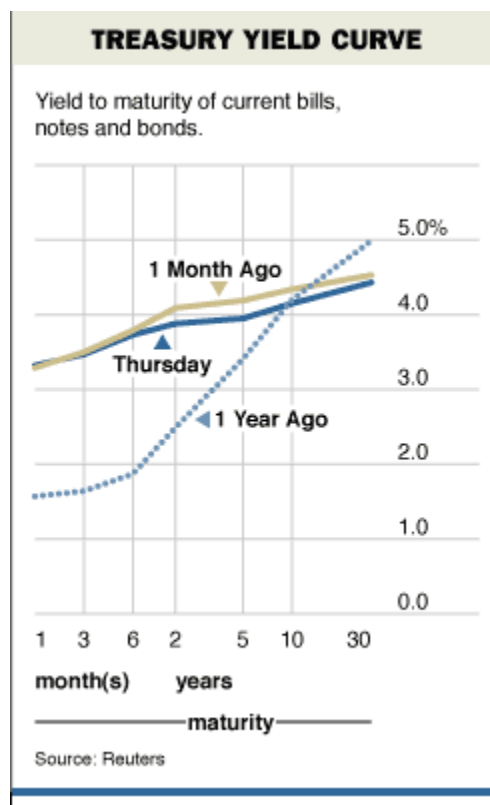
Just as with Katrina's potential fallout on the economy, there are many moving parts to the municipal-bond story. Not everyone feels the insurers will be forced to sell significant amounts. Much of the damage has been from floods, which

property and casualty companies don't insure, said Evan Rourke, a municipal strategist with Popular Securities Inc., the brokerage unit of Popular Inc. Flood damage is available only through the federal government.

Much of the damage in New Orleans and in Louisiana is flood damage. "They don't insure it, so they won't have to sell bonds for it," Mr. Rourke said.

He said he had seen one estimate in which \$15 billion to \$40 billion of the \$200 billion in potential damage was covered by private insurance. "When you account for reinsurance and the time frame over which claims get paid out, I don't see it as a big, big deal," he said.

Mark Rouck, an insurance-company analyst at Fitch Ratings, agreed. Large, national property and casualty companies tend to have strong operating cash flow and well diversified portfolios, he said. While they may have to sell some bonds to fund losses, "I don't think it's a given that it would put pressure on municipal bonds. They could sell corporate bonds. They could sell mortgage-backed securities."



Data as of 9/9/2005

The insurers might be expected at first to curtail their new municipal purchases until they know their exposure, said Michael Pietronico, a portfolio manager at Evergreen Investments, Charlotte, N.C. "I wouldn't necessarily expect to see selling right away," he said.

While the insurers are "big players," the market's supply picture doesn't seem to be so heavy that selling would be a particularly large problem for the market, the portfolio manager said. "It just seems to be, on the margin, a slight negative."

Longer Treasury maturities rose slightly, but prices of short issues eased on remarks by a Federal Reserve official. Speaking in San Diego, Federal Reserve Bank of San Francisco President Janet Yellen became the latest official to suggest that the Fed would be reluctant to pause in its interest-rate increases at its Sept. 20 policy meeting.

She said Hurricane Katrina has added to "upside" inflation risks. "Even with inflation expectations well contained...higher oil prices may be partly passed through to core inflation at least for a time," she said, and the storm may drive up "the prices of building materials and transportation services." While the storm is a "human tragedy," she said monetary policy can't be directed at a particular region and takes time to take effect."

So if an investor believes that there will be a rising interest environment for some time to come, where are the best and worst places to position assets?

The last period in which interest rates ratcheted up for any extended period was in the early 1990s. During that time, the equities markets had very definite winning and losing sectors, and we would heed the lessons of the past. Among the worst-performing sectors were insurance companies, banks, real estate investment trusts, and utilities issues. The best performing stocks were consumer staples and medical companies.

Two years before the significant rate hikes seen in 1994, the AMEX Pharmaceutical Index was down 19%; during the rate hikes, the index rose 24%. Before the rate hikes, the S&P 500 Financials Index was up 37.5%; in the rising interest rate environment of 1994, it was up only 8%.

There is a difference in the scenario offered in 1994 and the one we find ourselves in now, and that is in the driving forces behind rising interest rates now: significantly more storm activity and cooler temperatures worldwide.

I was recently interviewed by Ingo Narat of the leading German financial daily *Handelsblatt* for an article exploring whether money managers were positioning their clients' assets with an awareness of the possibility of climate change as a major new trend. I can't speak for others, but at Fraser Management we have focused on this issue for some time, and we believe there are outstanding opportunities to profit as a result.

□ Alex Seagle

Our thoughts and prayers are with the victims and families of the victims of Hurricane Katrina. Fraser Management has made a donation on behalf of our clients to the American Red Cross Relief Fund.

A Note on Katrina's Economic Impact

Total economic losses from Hurricane Katrina and the subsequent flooding of New Orleans are now projected to reach \$125 billion, according to Risk Management Solutions (RMS), a company that provides catastrophic risk data to insurers.

RMS said that at least 50 percent of the total economic loss from the disaster would come from the flooding that occurred after the hurricane passed, and the company warned that it would take months before an accurate assessment of the damage caused by the flood could be reached.

The breakdown between wind damage and flood losses is important because standard commercial and residential insurance policies in the U.S. exclude flood losses, and most flood insurance is underwritten through the federal national flood insurance program. Some high-value residential and commercial properties are covered by private-sector excess value policies.

Getting Older is No Fun

The United Nations periodically publishes a list of the 12 most populous nations. Back in 1950, this list included six nations from the "first world" (the United States, Japan, Germany, the United Kingdom, Italy, and France) and one from the "second world" (the Soviet Union). By 2000, only four of these nations remained on the list. In the UN projection for 2050, only one "first world" country remains -- the United States. According to political scientist Samuel Huntington, "the juxtaposition of a rapidly growing people of one culture and a slowly growing or stagnant people of another culture generates pressure for economic and/or political adjustments in both societies." Over the next few decades, Americans will be asking just how these adjustments may reshape tomorrow's global order.

A trend the Contrary Investor sees as much under-appreciated is the rapidly aging population in developed nations. Everyone is familiar with the notion of the "baby boomer", but this demographic is aging more rapidly than most people are aware. The primary cause of the coming demographic revolution is falling fertility. Since the 1960s, birth rates have declined steadily throughout the developed world (and in most of the developing world as well). But whereas in the United States fertility has stabilized at just under 2.1 births per woman, which roughly assures a stationary population, it has fallen much further in other countries: to 1.5 in western Europe overall, 1.4 in Japan, and 1.2 in certain southern European nations such as Spain and Italy. In most of these countries, people live at least as long as in the United States and immigration is much lower. Together, these trends produce very rapid aging.

Superimposing these dramatic demographics on extravagant pay-as-you-go retirement systems creates the fiscal equivalent of a perfect storm. Monthly public pension benefits and tax levels in most of the countries in question are considerably higher (relative to worker wages) than in the United States, and their retirement ages have been dropping even faster. It is common for European workers to retire in their late fifties, often on

special disability or unemployment arrangements. In France, only 39 percent of men aged 55 to 64 remain employed, versus 65 percent as recently as 1980. These super-aging societies will also consume more health care. According to the Center for Strategic and International Studies, total public benefit spending on the elderly in Japan, France, Germany, and Italy is projected, on average, to climb from 15 to 28 percent of GDP over the next 40 years. That figure is greater than the total revenues collected at all levels of government in the United States today.

To pay for such costs, these countries may try raising taxes. But many of them already have tax burdens of over 45 percent of GDP and payroll tax rates of over 35 percent of wages. At these lofty rates, many mainstream economists warn that further tax hikes may slow the economy more than they will raise new revenue.

Of course, political leaders can propose trimming benefits, but here they will encounter stiff resistance, because the elderly in these countries are so dependent on public benefits, which in turn are vigorously defended by powerful trade unions and their political allies. In continental Europe, employers do little pension saving on behalf of workers. According to a Merrill Lynch study, only seven percent of Europe's workers are covered by corporate pensions and only one percent by 401(k)-type savings plans. Household savings rates are higher in Europe than in the United States, but the savings are heavily skewed by income. Most median-earning households

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have little to count on except the promise of a government check. So, whether in Paris, Berlin, or Rome, the political leader who suggests even minor benefit reductions is typically greeted by general strikes and mass demonstrations. Washington's foreign friends, in other words, will face the wrenching dilemma of whether to fund weapons or walkers even more than the United States will.

In the end, governments in the developed world will patch together some fiscal expedient to tide them over. But one thing seems certain: they will be subjected to intense pressure to slash other spending and run larger budget deficits. The cuts will probably include defense, security, and international aid. And leaders will grow even more reluctant than they are already to commit public resources to U.S.-led military actions or nation-building operations. Meanwhile, private-sector savings rates are almost certain to fall as the number of retired households rises and the number of working-age households declines. Larger budget deficits combined with declining private savings will end, and perhaps even reverse, the large current account surpluses that these countries have historically generated over the postwar era.

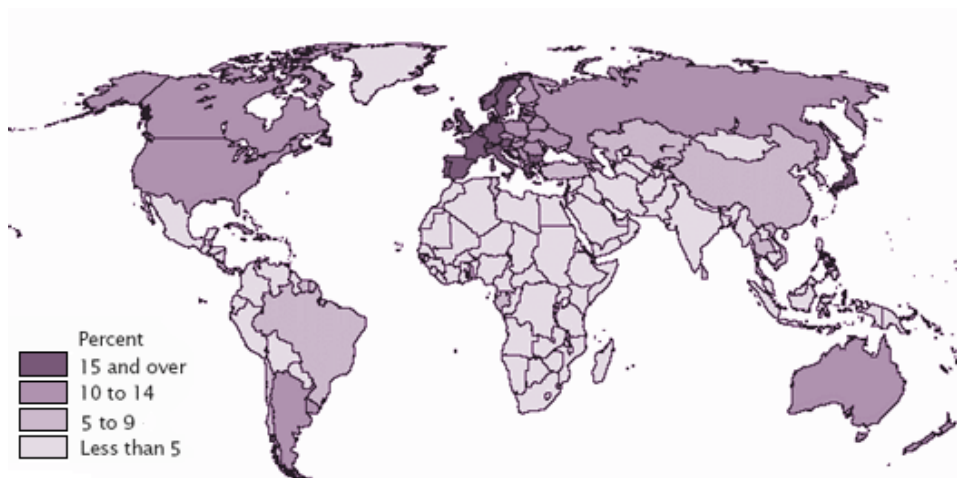
In the longer term, low fertility will mean not only a fiscal squeeze but also an accelerating population decline. This too will have profound consequences in developed countries. 946 and 1964) begins to turn 65.

The rate of GDP growth can decelerate and even shift into reverse in those countries in which the rate of workforce decline exceeds productivity growth. Outside the United States, the population of the developed world is peaking now. By the early 2010s, assuming no change in fertility, it will decline by about one million people per year; by the late 2020s, by about three million per year; and in the 2040s, by over five million per year.

But aging, and the impact on so many sectors of our economy, remains our chief concern. Since the 1950s, the number of older people (those ages 65 and older) has been growing gradually, but it will increase sharply beginning in 2011 as the baby-boom generation (born between 1946 and 1964) begins to turn 65. Today, roughly one in eight Americans are older, up from roughly one in 10 in the 1950s. By 2030, when the entire baby-boom generation has reached age 65, older people are expected to include almost one in five people. This share resembles Florida's population today. By 2050, the share will be slightly more than one in five.

The fastest growing segment of the older population is the oldest old — that is, those ages 85 and older. They are projected to total 6 million (in the U.S.) as early as 2010, twice their 1990 level. Beginning in 2031, when the baby boomers will begin reaching 85, the number of oldest old will increase rapidly. The 85-and-over population is expected to grow fivefold, from 4 million in 2000 to 21 million by 2050.

So what we have is a powerful trend that will impact how virtually every developed nation will allocate money for many years to come. The effects



Percent of population aged 65 or older
Source: U.S. Census Bureau, 2000 Census

Words to Consider

The reasonable man adapts himself to the world; the unreasonable one persists in trying to adapt the world to himself. Therefore all progress depends on the unreasonable man.

~ Robert Heinlein

So much of what we call management consists in making it difficult for people to work.

~ Louis "Satchmo" Armstrong

According to a new survey, 90% of men say that their lover is also their best friend, which is really kind of disturbing when you consider that man's best friend is his dog.

~ Jay Leno

In three words I can sum up everything I've learned about life: it goes on.


~ Robert Frost

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will be seen dramatically in healthcare and military spending. But we will also see foreign governments begin to reallocate dollars that presently go to support the debt of a whole host of nations, including the United States. If nations such as Japan decide to scale back investment in U.S. Treasury debt to address the needs of their aging population, the reverberations will be widespread.


Also interesting will be the reaction of an aging population at the voting booth as choices are made as to how to allocate dollars. A high percentage of seniors vote, and the politicians responsible for spending decisions know this well. This is true here at home as well as in all the other developed nations facing the coming challenge.

□ Alex Seagle



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