Mark's Musings

Whitmore Capital Management Quarterly Newsletter

Q3, 2013 December 30, 2013

"In progressive societies, the concentration of wealth may reach a point where the strength of numbers in the many poor rivals the strength of ability in the few rich; then the unstable equilibrium generates a critical situation, which history has diversely met by legislation redistributing wealth or revolution redistributing poverty."

- Will Durant

The Tale of Two Economies

According to Forbes, the top 1%, or slightly more than three million people, own approximately **$21 trillion** in wealth, while the bottom 80% (including all of what is considered the middle class and many of those considered to be upper-middle class) own only about $3.75 trillion of total wealth. That latter number might seem to be a large sum on its face. But the average net worth of the bottom 80% is only a bit higher than $15,000, while the average net worth of the top 1% works out to be roughly $6,500,000. It has not been since the Harding administration, almost ninety years ago, that wealth inequality between the very rich and the rest of society has been this vast.

If one widens the extremities even further when looking at this issue, the results are an even greater affront to one's conscience. According to Forbes again, the wealthiest four hundred Americans have virtually the same combined net worth as the poorest 150 million individuals, or almost half the nation!

Back when I was just a cranky individual investor with a blog, I wrote that not only were TARP and quantitative easing destined to be failed policies, but they were moral travesties to our nation. While many sound minds would vigorously debate my opinion that these policies have not been efficacious, I think the division of national spoils over the last several years make it obvious that the consequences of corporate welfare to Wall Street, the least needy and most culpable institutions for the financial crisis to begin with, combined with allowing these same entities to have virtually unlimited access to zero-interest funds, have been quite odious.

Marc Faber recently reported on the work of Larry Lindsey, who, though careful analysis of the Federal Reserve's own *Survey of Consumer Finance and Flow of Funds*, was able to make some startling discoveries concerning wealth inequality over the last six years. While it is true that aggregate household wealth has now exceeded that of the pre-crisis 2007 peak (something about which the Fed likes to beat its chest in pride), the 155+ million US citizens in the bottom 50% have seen their net worth **decline by almost 45%**, or over $700 billion, dropping from almost $1.6 trillion at the 2007 peak to an estimated $887 billion level today. According to Lindsey, not only have the very wealthiest Americans failed to lose money compared to the peak of the 2007 asset bubbles, but due to the effects of TARP and QEx, they have prospered. While the average individual living in the bottom 50% saw almost half of his net worth evaporate between 2007-2013, the average one-percenter saw his net worth go up by more than $135,000.

Not surprisingly, in addition to total wealth diminishing for anyone not in the top 10%, most Americans have seen their inflation-adjusted incomes decline as well. According to the Wall Street Journal, the bottom 90% of wage-earners have seen a greater than 10% decline in real income between 2002 and 2012. Personally, I think this figure is even larger, as inflation is notoriously under reported in the US.

In sum, we are left with a snapshot of a nation in which the pie is barely growing (very sluggish GDP growth), while it is being cut up in a manner favoring those individuals (the very wealthy) and institutions (the banking industry and those dependent upon it such as real estate) who can take advantage of financial alchemy in a zero-interest rate environment. The fact that **fully 50% of the nation own less than 1.5% of the nation's wealth** indicates that too many are left with crumbs. Yet despite this, the delusional neo-Keynesians argue that whatever shortcomings there might be in terms of economic progress are because their failed policies were not taken to big enough extremes. Paul Krugman and his ilk would claim that the reason why economy is barely growing despite the fact that the Fed has spent **$4 trillion** on its quantitative easing programs is because that figure was too low!

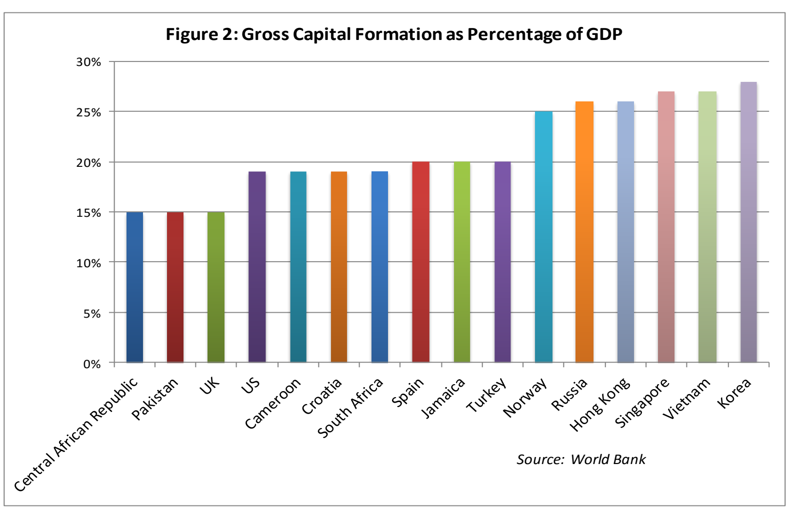
As a student of history, I have often thought about the situation described above in the quote from Will Durant. Sadly, in the intervening forty-five years since Durant penned those words in *The Lessons of History,* I would argue that governments have proven themselves to be almost as adroit at "distributing poverty" (under the guise of redistributing wealth) as revolutions. The real goal should be preventing a situation in which wealth inequality becomes so disparate; I am afraid there are no easy fixes once the concentration of wealth in the hands of the very few becomes this extreme.

So other than sad socio-economic commentary on the United States, why do I dwell on this? Essentially I remain doubtful that any sound, lasting economic recovery can be obtained while only a small sector (finance) and a small group (the very rich) prosper greatly, while the vast majority of companies and people languish at worst, or plod along at best. So while the markets and many sanguine market commentators continue to disregard my concerns, I remain skeptical that the health of the US economy and its asset markets are nearly as robust as domestic equity indexes would indicate.

Making matters more disconcerting, we have very little domestic capital investment. The latest available numbers from the World Bank looking at gross capital formation as a percentage of GDP is quite revealing. Coming in at less than 20%, the US is on par with Cameroon, Croatia and South Africa. Thankfully we are meaningfully ahead of Pakistan, the Central African Republic and UK (another reason I am bearish on the pound), each of whose investment in fixed assets does not exceed 15% of GDP. We are

"[those betting on further huge asset market gains are] playing a game of musical chairs with fewer and fewer seats remaining the longer the music plays."

Exhibit 1. Gross Capital Formation as a Percentage of GDP



"… it pays to be greedy when others are cautious, and cautious when others are greedy."

slightly behind such countries as Jamaica, Turkey and economic-basket-case Spain, all of which invest at least 20% in capital formation. Finally, we are meaningfully behind Russia, Hong Kong, Korea, Norway, Vietnam and Singapore, as these countries have gross capital formation percentages in the 25-30 range (see Exhibit 1).

Obviously then, the (unsustainably) high corporate profits (see last quarter's newsletter) are generally not being plowed back into companies to increase productive capacity. Rather, they are being used to fund share-buybacks, build corporate war chests that can then be used to buy other companies, or tend to get distributed as dividends. All of these things are examples of financial engineering, whereby the pie gets distributed more favorably to the owners of capital, but it does nothing to expand the size of the pie itself.

The fact that these record profits are not being generated by expansion of operations so much as cost-cutting, down-sizing and technological enhancements is also troublesome. The last factor does not help the typical wage-earner, while the first two factors actually hurt him (obviously contributing to the aforementioned decline in real wages for 90% of the population).

None of this would appear to bode well for the prospects of healthy growth and continued recovery of the economy going forward. Yet prospective economic blue skies are unquestionably priced into domestic asset markets. This does not even begin to address the fact that we as a nation continue to write a social contract that we cannot afford, and which will thus be voided at some point. Hence, I remain convinced that it is prudent to be largely defensively postured going forward. Now this does not mean we cannot have another "blow-off" period of exuberance in markets, particularly equities, for a period of months. I just would not like to be betting on that, as it is akin to playing a game of musical chairs with fewer and fewer seats remaining the longer the music plays.

I expect all of this means that regardless of the near-term outcome, fund volatility will be heightened going forward. It also means that I continue to urge general caution as investors think about deploying other assets. As a general rule of thumb, I have found that it pays to be greedy when others are cautious, and cautious when others are greedy. At least in the financial markets, there is a great deal of greed and complacency, while the fundamentals of our economy look increasingly problematic.

*** Past results are not necessarily indicative of future results. You should carefully consider whether your financial condition permits you to participate in a commodity pool. In so doing, you should be aware that commodity interest trading can quickly lead to large losses as well as gains. Such trading losses can sharply reduce the net asset value of the pool and consequently the value of your interest in the pool. References to specific securities and issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities.**

3Q 2013 Performance Summary: When One Hates to be Right

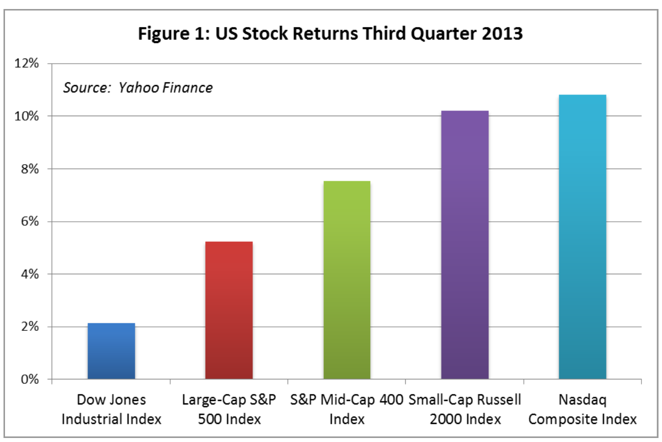
As some of you may recall, the quote on the sidebar of last quarter's report was from Bette Davis' character in the excellent movie, *All About Eve*, "Fasten your seatbelts. It's going to be a bumpy [ride]." One may also recall my admonition concerning the fund's theretofore 1) lack of volatility and 2) nothing but positive returns. Namely, that all of the gradual, steady gains from the second quarter and more could be wiped out in a bad month.

While I would have preferred to be wrong on both counts, the third quarter proved to be one of underperformance for Whitmore Capital LP. While July and August were both solid positive months for returns, coming in at 4.06% and 1.58% respectively, September proved to be disastrous, with the -8.64% loss indeed wiping out all of the second quarter's gains and then some. Overall then, Whitmore Capital LP was down 3.4% for the quarter.

Note: In the period between the end of 3Q 2013 and the publication of this letter, the Fund has received finalized performance figures for October and November, 2013. The investment results for these months are 6.25% and –6.85%, respectively.[1]

By way of comparison, the Credit Suisse Hedge Fund Index was up 1.6%.[2] I continued to be somewhat defensively postured in the third quarter, which largely explained Whitmore Capital LP's quarterly losses. Risk assets had an exceedingly excellent quarter, as manifested by a comparison of the stodgy Dow Jones Industrial Index, the Large-Cap S&P 500 Index, the S&P Mid-Cap

Exhibit 1. US Stock Returns in Third Quarter of 2013



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[2] About the Credit Suisse Hedge Fund Index. This index is compiled by Credit Suisse Hedge Index LLC. It is an asset-weighted hedge fund index and includes only funds, as opposed to separate accounts. The index uses the Credit Suisse Hedge Fund Database, which tracks approximately 9,000 funds and consists only of funds with a minimum of US$50 million under management, a 12-month track record, and audited financial statements. The index is calculated and rebalanced on a monthly basis, and reflects performance net of all hedge fund component performance fees and expenses. The particular funds that comprise the index may have rates of return that are significantly different and/or more volatile than those of the index. Finally, while individuals may invest in a particular fund included in the index, they may not invest in the index itself.

400 Index, the riskier Small-Cap Russell 2000 Index and finally the high-flying Nasdaq Composite Index (see Exhibit 1).

I expect fund volatility to remain at significant levels, and that volatility overall will likely spike in other asset markets going forward. The S&P 500 is up more than 165% since its March 2009 lows. Yet the divergence between Wall Street and Main Street continues to grow, as the malignant effects of crony capitalism in the US manifests itself in a variety of disturbing ways (see piece below).

Overall the currency markets performed in a manner consistent with the state of ebullient optimism that pervades most domestic asset markets. During the quarter, Whitmore Capital LP saw solid profits on its positions in the Russian ruble and Singapore dollar, as well as the short positions it had in the Turkish lire. More than offsetting those gains, the fund saw significant losses being short the British pound, as the cable rose an eye-popping 6% for the quarter. Finally of note, the New Zealand dollar appreciated significantly, reversing most of the gains Whitmore Capital LP saw in the second quarter by being short the Kiwi currency.

While Whitmore Capital LP's third quarter performance was disappointing, I continue to be encouraged by the fund's cumulative returns, which stood at almost 50% net of all fees over the fund's first sixteen months of existence. As all of my investors know, I place very little stock in the short-term vagaries of market gyrations, other than to hopefully use movements against the fund to get better pricing on certain positions that have very attractive longer-term prospects.

During the quarter, we changed our benchmark from the Credit Suisse Core Hedge Fund Index to the broader Credit Suisse Hedge Fund Index, as the former is no longer being published. Of issue may be why I chose a broad hedge fund index as a benchmark as opposed to a specific currency index, such as the Barclay Currency Traders Index. It is true that the latter is a better benchmark to use, as Whitmore Capital LP exclusively invests in currencies. However, given the very poor returns that this index has had over the last decade (less than 2%/yr. on average since 2004), I felt that Whitmore Capital LP investors would be far better served with a benchmark that has had much better returns.

Nevertheless, the fact that the vast majority of currency funds continue to languish as a group (see *Currency Investing: An Alpha-Rich Environment*, included in my October email to investors), particularly in the last three-year time period, while Whitmore Capital LP has performed quite well, gives me even greater confidence that the long-term, value-based approach guiding fund strategy is the correct one.

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WHITMORE CAPITAL MANAGEMENT

About Whitmore Capital Management, LLC

Whitmore Capital Management, LLC was formed in 2012 to offer investors access to a proprietary foreign exchange investing program (the Fund, Whitmore Capital LP). This program focuses on cash currencies but may also include futures, forwards and currency options. The objective of the Fund is to achieve long-term returns superior to the Credit Suisse Hedge Fund Index.

At the very core of the investing program is a mathematical model developed by Mark Whitmore. This proprietary calculus for determining the "fair value" of exchange rates aims to identify long-term opportunities to profit from temporary currency market mispricing. The outcome of these quantitative analyses are supplemented by qualitative analyses of the circumstances surrounding each currency to determine the configuration of the portfolio itself. Finally, sentiment indicators are reviewed as an additional analytical overlay. Currencies traded for the Partnership's account may include, but are not limited to, pairs of the following currencies: AUD, CAD, CHF, CNH, CZK, DKK, EUR, GBP, HKD, HUF, ILS, JPY, MXN, NOK, NZD, PLN, RUB, SEK, SGD, TRY, USD, ZAR.

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