Austrian Finance and Investing in Times of Uncertainty

John E. Charalambakis Ph.D.
BlackSummit Financial Group

Foundational Principles

- Investment action is essentially purposive; its objective is the removal of uneasiness not necessarily maximization under constraints
- The means & ends (sources & uses of funds) framework points to the ongoing evolution of subjective understanding and thus the IRR is a range rather than a single number
- Indeterminism and the element of surprise events should make decision makers (financiers and investors) alert to entrepreneurial perceptions of market opportunities which always have to be judged using rules of thumb
- Reliance solely on information conveyed creates biased estimates and systemic risks. Entrepreneurial activity is about outguessing market prices when the latter do not seem consistent
- The efficiency market hypothesis is a myth since non-price information may be more valuable than prices are

Foundational Principles

- Value is found in the utility. The latter is determined by individual subjective judgment, by the interaction of market forces, and by social valuations
- Proper discounting is necessary in valuation models
- Failure to account for the real costs, distorts capital allocation and leads to malinvestments
- Comfortable margins are needed so that cushions protect and preserve capital
- Introspection and the time dimension: Questioning the answers while valuing spontaneous entrepreneurial discoveries

Foundational Principles

- Uncertainty is endogenous by nature and is reinforced by attempts to reduce it. Unlistability is the inability to list all possible outcomes in the abnormal distribution of possible outcomes
- The alpha for the investor can be generated by the ability of the agents to interconnect events, tie them to fundamental rules, and exploit limited profitable possibilities from the repertoire of options available
- Financing and investing entails "prophesizing" in the ancient norm of prophesy i.e. comprehending the true state of affairs and hedging against it
- Finance and investment nowadays need more and more the "spontaneous" and "evolutionary" element of Hayek

Applying the Principles

- Comprehending the sources of risk including signs of macro-tail risks arising from over-leverage which becomes the source of a boom and which in turn becomes the basis of the bust
- Portfolio management cannot be considered efficient unless it encompasses a notion of investments that are solidified around hard-assets with intrinsic value
- Assets that represent third-party liabilities are destined to a major shake up when the postman rings the bell of the bond market
- The unfunded liabilities and hidden (off-the-balance sheet) debts should direct portfolio management to fixed income investments which are hard-asset bound

Applying the Principles

- Symptoms vs. Causes: The role of anchors and the "predictability" of crises
- Financial Crisis: Derivatives lessons not learned yet
- Financial repression is a symptom of the greater cause that is called cheapening of currencies (Roman catastrophe)
- Financialization does not produce wealth: The schizophrenia of bifurcation between industrial and financial capital
- There cannot be investment miracles unless are based on real gains in productivity ("Asian Miracle")
- Realizing what capital is
- Orwell vs. Huxley

Applying the Principles

- Preparing for the ultimate bust (due to collateral holes, overextension of credit, credit and liquidity issues, margin calls, etc.) which bust will change the monetary landscape
- Level 3 type of assets that are purely based on firm's own algorithms will render central banks ineffective since paper asset prices are either precisely wrong or vaguely right
- Manufactured securities market has lost its direction since re-hypothecation undermines risk management and raises uncertainty to an unthinkable exponential
- Reckless financing (e.g. 7-10+ times EBITDA) creates toxic assets that greater fools buy
- Models like VaR simply accommodate vested interests

Applying the Principles

- Preservation of capital and sufficient safety margin when deploying that capital
- Bias for hard assets that do not have counterparty risk
- Sustained income streams from asset classes that have intrinsic value. Consideration is given to free cash flow and debt coverage in addition to dividend yield
- A portfolio that is anchored on evolutionary thinking within a hard asset perspective
- Macroeconomic fundamentals (such as debt, demographics, trade and fiscal imbalances) that guide the core of portfolio holdings and are able to assess the cyclical component of risk
- When uncertainty and high volatility prevail, employ hedging strategies in order to mitigate risk and preserve capital

Applying the Principles

- Exploit inefficiencies in the market using various options strategies to enhance portfolio return
- Once a target has been achieved, outright profit-taking, position reduction and/or stop loss measures may be employed to ensure that we lock in existing profit and protect against a possible period of consolidation
- A global perspective that analyzes market fundamentals, encompasses technical and spontaneous time elements while considering geopolitical dimensions
- Identification of dormant assets that have intrinsic value
- Ignoring technological trends is a betrayal to the evolutionary adoptability

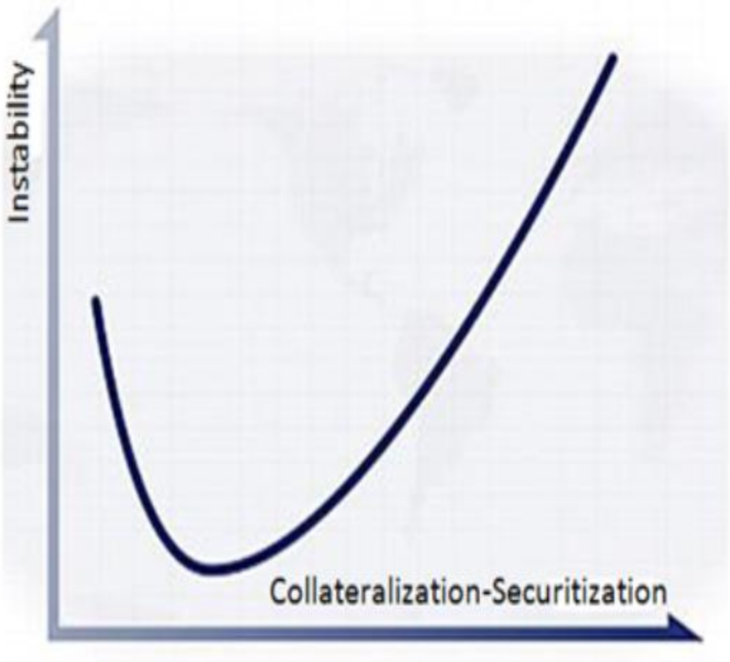
Applying the Principles

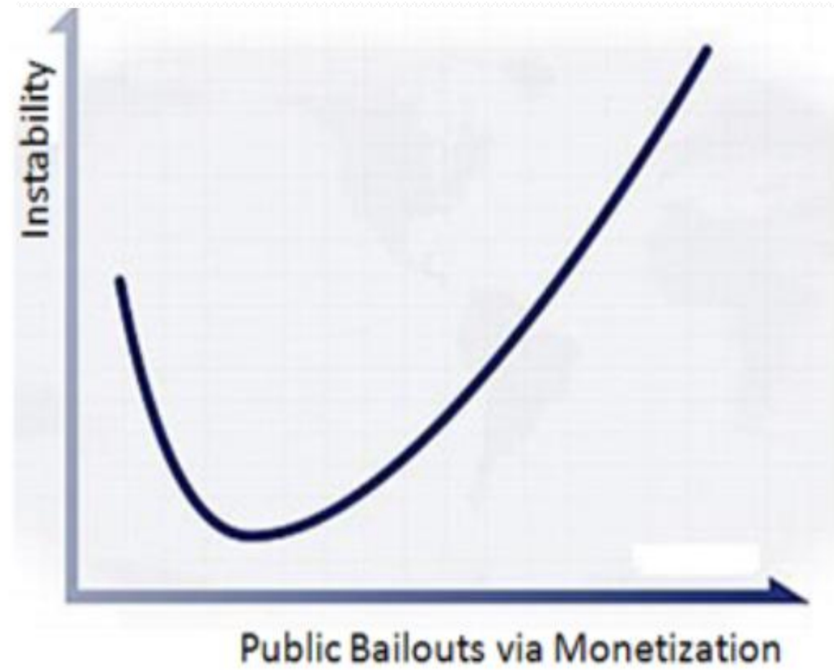
- Asset classes whose value is below their historic 5-year average (cyclically adjusted) and whose business generates sufficient and growing earnings. Emphasis is placed on dividend growth history
- Businesses that have a significant market share, enjoy some barriers to entry, and whose competitive advantage separates them from the crowd
- Businesses that have profit margin power, sufficiently positive free cash flow, and pay a healthy dividend that is at least 100 bps above the 10-year Treasury note
- Businesses whose management has exhibited strategic competencies demonstrated in growing sales, executed with professional ethical power and which historically have enjoyed strong balance sheets with major emphasis on prudent use of leverage
- Exploiting ETFs of industries and sectors that hold the above principles and goals

Market Entropy & Trajectory

- Probabilistic expectations tend to have an escape velocity because of the evolutionary nature of counter-party-risk and due to power shifts
- The distribution of outcomes affects human action. Human action is guided by self-interest. Self-interest is pre-destined by power. Power shifts create instability. Goal therefore is to foresee the trajectory of power shifts
- Scarcity of saved capital is destined to unravel the production process which leads to what Rothbard called "crisis situation"
- Market entropy/disintegration is built into the DNA of the securitization process when anchors are absent leading to the co-movement between instability and securitization

Market Entropy & Trajectory





Conclusion: Useful Idiots for How Long?

- As monetary entropy accumulates into the economic system in the form of credit extensions via re-hypothecation of paper assets and derivatives structures, it necessarily leads to greater imbalances in trade, capital flows, employment, and liabilities, leading ultimately to mother of all crises which will be shown and exemplified by liquidity squeezes and frozen credit markets that will render production and trade obsolete
- Investors will eventually seek the ultimate haven-anchor that preserves wealth, has intrinsic value, cannot be printed, does not erode with time, and which can assist in the unraveling of the systemic and confused disequilibrium that paper assets and their re-hypothecation have produced
- Just imagine what would happen if investment managers converted 3-5% of their holdings to precious metals as a precautionary move. Until then they will remain useful idiots in a game that is marked for financial death