May 12, 2023

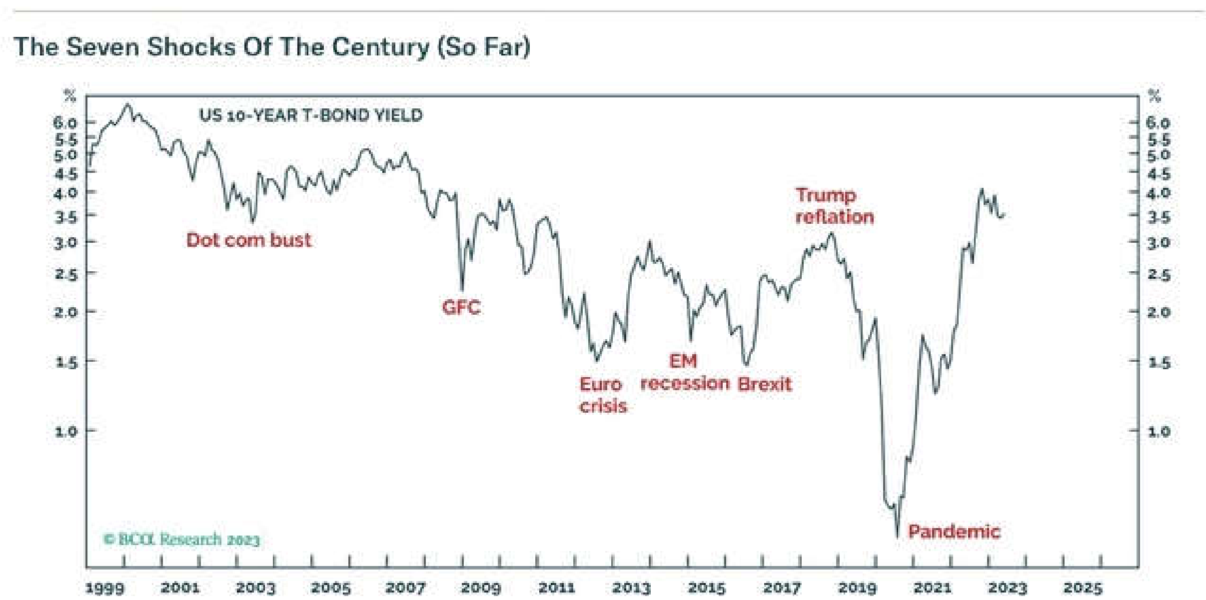
Dear client,

Special Report

Why Portfolio Insurance May Be Warranted

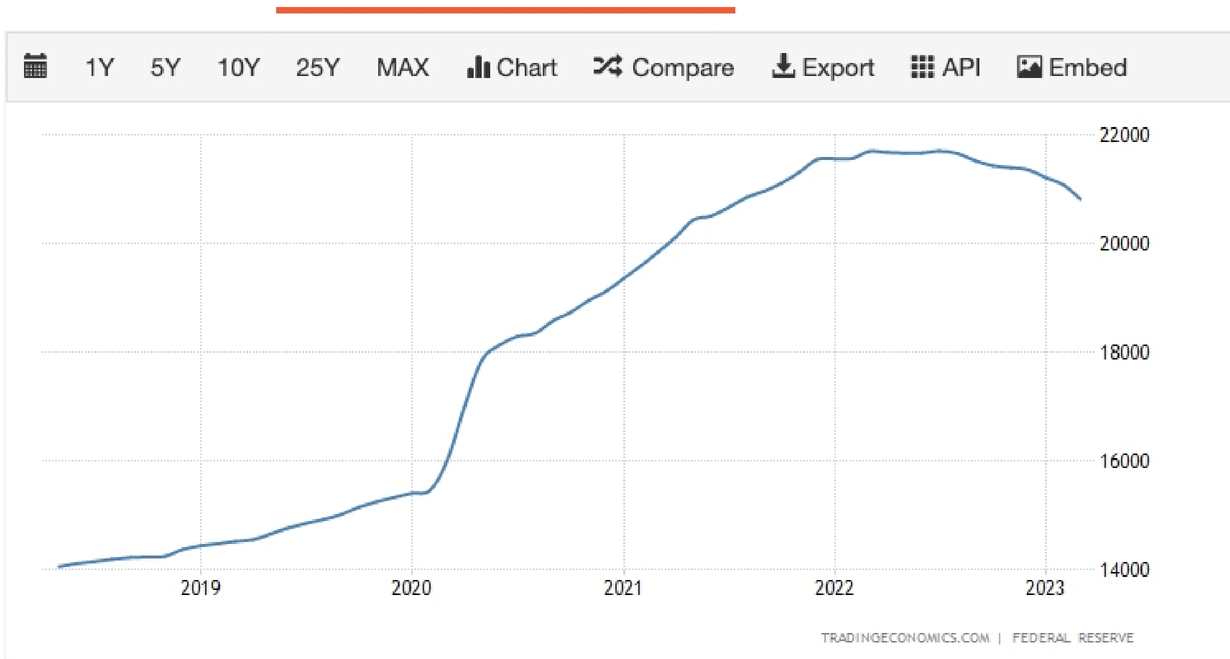
By *Steven Lee Yamshon, Ph.D., Managing Principal*

Every few years, the possibility of either a political, economic, or natural event has a 50% chance of occurring. According to BCA's Counterpoint strategy, the odds of an event that affects the financial markets increases to 96% over a decade. Therefore, it was interesting for me to read this strategy report because I have studied the boom-to-bust cycle over the many years of my career. In fact, my doctoral dissertation was titled, "*Human Action and the Securities Markets"* in which I was one of the pioneers that was able to examine and tie together Modern Portfolio Theory (MPT) and the Austrian Trade Cycle Theory otherwise known as the boom-to-bust trade cycle.



Markets move from pessimism to optimism, back and forth like a pendulum. At times, the market is euphoric such as in 2000 and 2021 where investors are willing to pay almost any price for a stock, bond, or any other investment. Then, suddenly, the pendulum swings back and investors don't want any security at any price. This would lead one to believe, at times, the market is psychotic, and at times, the market is just that, irrational as it can be rational.

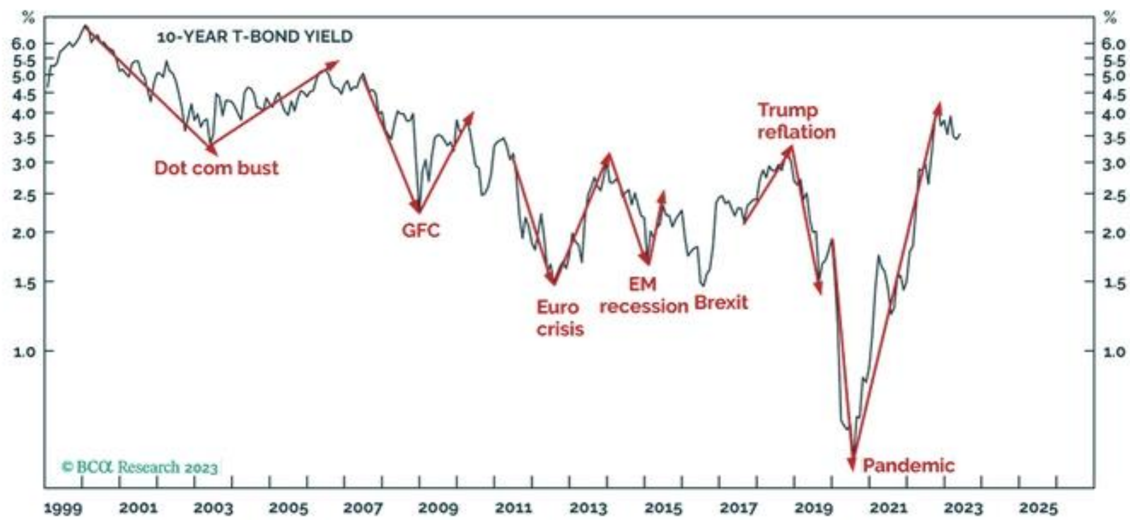
We can see this pendulum swing in action as we watch how the U.S. Federal Reserve Bank implements its monetary policy. In 2020, the government was loose with its credit and money which lead to a jump in asset prices in 2021 as there was a corresponding increase in inflation. As inflation spiraled out of control, the U.S. Federal Reserve backed off, shrunk the money supply, and increased interest rates. The chart below illustrates the massive injection of money from 2020 through 2022 and the corresponding decrease in money after 2022. There shouldn't be any wonderment as to why stock prices collapsed last year.



The tightening of the money supply (M2) since 2022 has influenced slowing inflation, but not lowering it enough. In addition, higher interest rates have caused collateral damage to the banking system. At some point, when interest rates go from 0% to 5.0%, the financial system will show some cracks in it. At some point, a recession will occur and we go back to the deflationary cycle as the bubble is pricked (Chart I-7). As the economy goes from inflation to deflation, the Federal Reserve will begin to expand the money supply and cut interest rates to at least 2% if not zero and the cycle will start all over again. This is the classic boom-to-bust cycle in which a system that is not backed by gold or commodities experiences. Incidentally, the same thing occurred in 1998-2000 when the dot com bubble burst and in the great financial crisis of 2008-2009.

Chart I-7

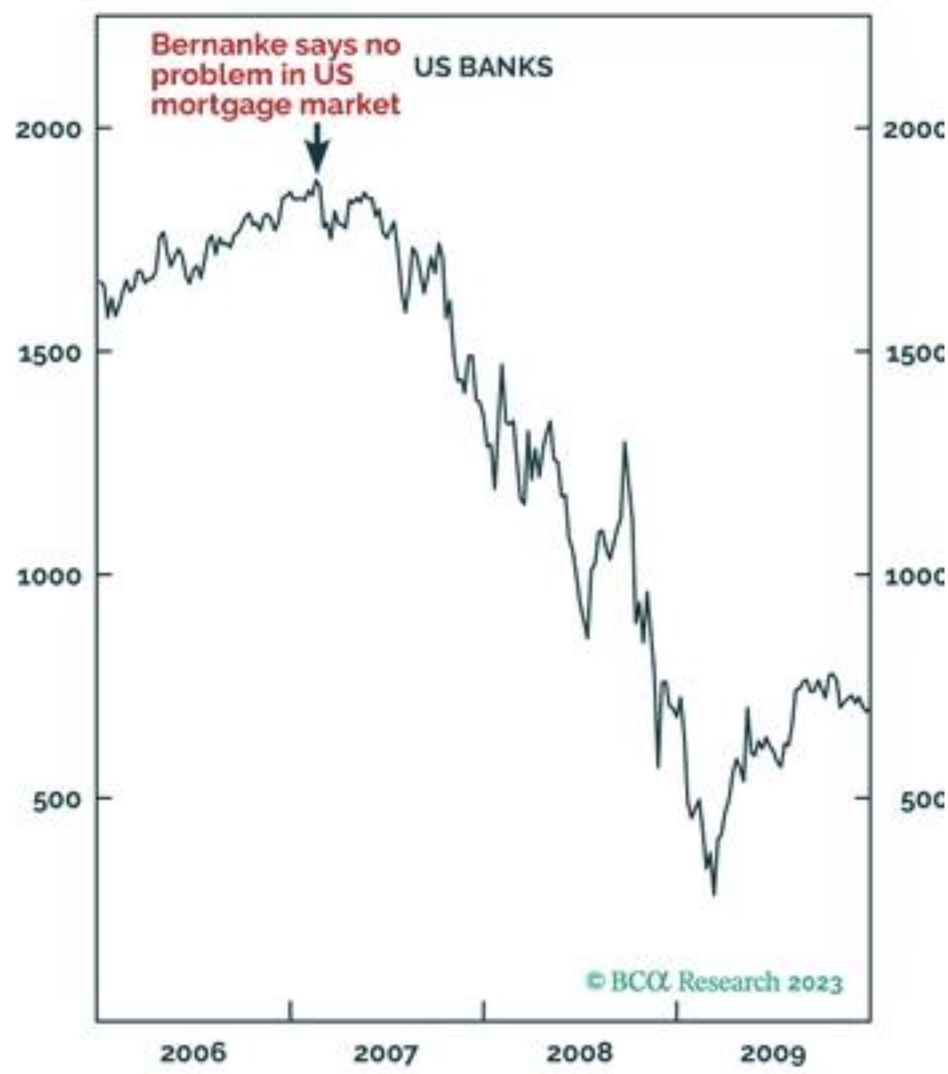
Each Shock Has A Deflationary And Inflationary Component



It seems that every 10 years we have a major financial occurrence with minor ones in between. In my opinion, if the system is not backed by gold or commodities, then this will continue. Nassim Taleb, who wrote "*The Black Swan"* said that it isn't the probable event that you have to worry about, but the event that is less likely to occur. This is because many of the probable events are already factored into market prices. To be honest, it is very difficult to foresee an improbable event. Were the regulators aware of the Silicon Valley Bank and First Republic Bank failures? How come the Bank of England got blindsided when the UK pension funds needed bailing out last summer? In many cases, it is impossible to forecast an improbable event. Even Ben Bernanke, the Chairman of the U.S. Federal Reserve at the time of the Great Financial Crisis, couldn't see what was going to occur. (See Chart I-2.)

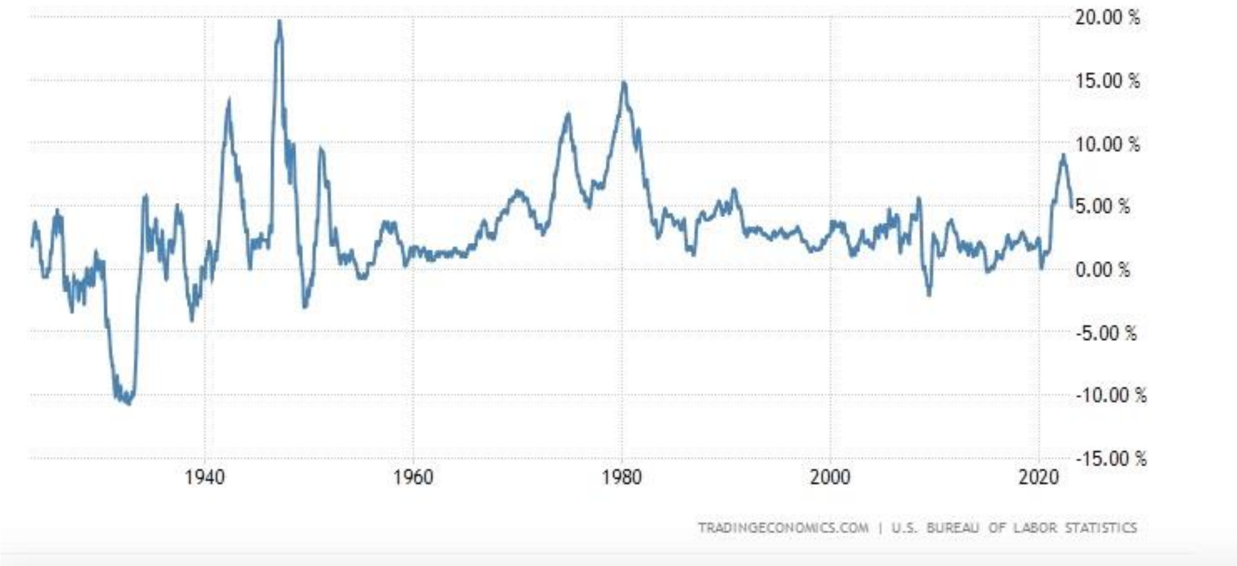
Chart I-2

Bernanke Couldn't See The GFC



On the horizon, without certainty, the U.S. dollar could lose its reign. Since the U.S. dollar became the global reserve currency in 1945, the U.S. has been able to borrow massive quantities of money, float debt, and at a lower cost than they could otherwise. Yet, the U.S. Government is mismanaging its fiscal responsibilities to the world by running trillion-dollar deficits and using the U.S. Dollar as a political weapon. It most likely will take some time for "king dollar" to be deposed because there is no real substitute at this time, although China wants their currency to replace the U.S. Dollar. This may be an improbable event that investors need to consider.

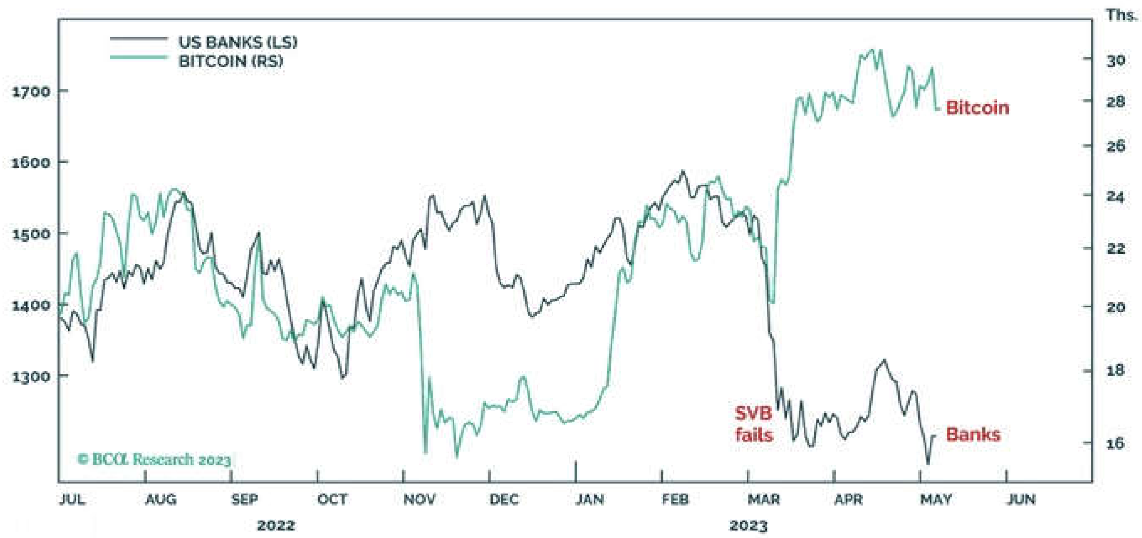
When Chen Zhao, my friend, was at BCA, he came up with a portfolio protector that consisted of the Japanese Yen, Swiss Franc, Gold, U.S. Treasuries, and the U.S. Dollar. I thought Chen's version of the portfolio protector was a bit messy, so I refined it. We don't use it permanently, but only when I think it will help protect the downside of the portfolio. Years ago, Benjamin Graham wrote a nice book that outlined the use of commodities to replace the long-abandoned gold standard. Graham, in the 1950's, was alarmed about the large increase in inflation since the beginning of World War II. The war ended in 1945, but inflation had not. I presented a paper at the Austrian Economics Scholars Conference in 2002, that made the case for a combination of widely used industrial metals stored in 12 warehouses in the United States that could serve as a backing of the U.S. Dollar. It was because of this research, I added silver to the portfolio protector. You can see by the chart below why Graham was so concerned.



At the current moment, gold, U.S. Treasuries, and silver are in the portfolio protector. At some point, we will be re-introducing the Japanese Yen and the Swiss Franc. Since our stocks are mostly denominated in U.S. Dollars, we don't need to buy dollars. At this juncture, I am investigating other types of portfolio protection. Although I have made no determination regarding the suitability of cryptocurrencies as a portfolio protector, it is interesting to see how cryptos have performed during this latest banking crisis (See chart I-8).

Chart I-8

Cryptocurrencies Rally When Banks Fail



We will be having our next conference call on Tuesday, May 16th, at 6:30 p.m. to discuss the banking turmoil, the US Debt limit, and the dollar. Please join us.

When: Tuesday, May 16th, at 6:30 p.m. (PST)
Topic: BFSG Conference Call Hosted By Steven Yamshon

Please click the link below to join the Conference Call.
https://bfsg.zoom.us/j/95587997509?pwd=aHkwMkVyL2dPSVdUQzRzT2NrSmVkZz09

Or Telephone: 1 (720) 707- 2699
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International numbers available, click link: https://bfsg.zoom.us/u/kAU6l2wFV

All the best,
Steve Yamshon, Ph.D.
Managing Principal