Investment Insight

ZANACORP

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We are just 1 year into the post COVID-19 world. Profound changes to the way we live, work, travel, spend and socialise are obvious. If the global economy was a battleship, the ship and crew would be operating at "red alert" status. This is typical of a vessel being armed and prepared for any present risks that could threaten its safety. In a curious irony, every government and central bank has acted exactly as it should, at red alert. Stimulus measures have generously deposited money into the bank accounts of citizens (both corporate and individuals) and interest rates reduced to "emergency" level lows of ...ZERO! However, these supportive measures to avert widespread catastrophe, appear to have been greatly misunderstood. The crew, in this case ordinary people, seem to be responding as if they are on recreation leave. Global private borrowing has reached record levels propelling 2021 property prices and sharemarkets to record highs. Confidence and post-lockdown "spending therapy" has been unbridled, exceeding all expectations. People have indulged themselves to compensate for their period of enforced confinement. A chilling disconnect has arisen between a global economy on life support and booming markets. Spenders have succumbed to cheap/easy credit and BNPL, whilst investors suffering FOMO fearlessly chase the easy riches of ever rising asset prices. The final stages of every bull market often look like this, only to be skittled by the unexpected. Will it be inflation? Don't forget Chaplin's banana peel and manhole skit. Winter is coming.

"It's The Liquidity, Stupid".....and TINA

Be prepared for 2021 to be the boom of the decade, for all the wrong reasons. What follows will be the first of a continuing series of articles exploring the basis of this bold statement.

Running Out Of Road

Readers of sufficient years may recognise the title of this Investment Insight. It is a twist on the ***"It's The Economy, Stupid"*** slogan used by Bill Clinton in his successful 1992 Presidential campaign.

At the time, the US was in the grip of a severe recession dealing with a plethora of domestic problems following the Gulf War. Government deficits, tax policy, unemployment, falling house/share prices, rising healthcare costs and homelessness were the major issues of the day.

Clinton used his catch cry to direct the attention of US voters on the key planks of his platform. He astutely and repeatedly focussed the minds of voters on the issues that most concerned them. He identified the ills and forged a specific plan to address them, including raising taxes. For some reason, **governments and people today lack that courage or will.**

The challenges of 2021 resemble those of the early 1990s. As well as the pandemic, our current day world is dealing with the repercussions of US/China trade tensions, crippling debt burdens, aged care issues, rising income inequality, youth unemployment, unaffordable housing, social unrest, fake news & cancel culture, reverberating endlessly everywhere.

Resolving the early 1990s problems demanded time, pain, resilience, co-operation and shared burdens. It is difficult to imagine the current malaise can be tackled any differently. Is that even possible though, with free speech muzzled and many no longer listen to any competing views?

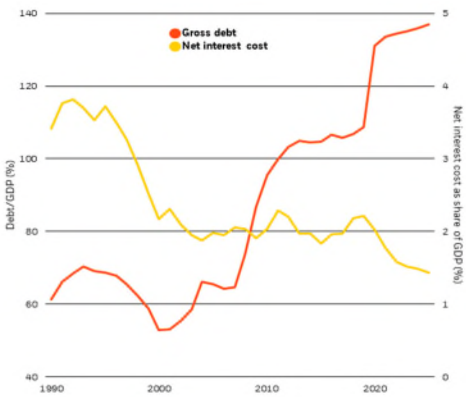
At the root of the current Western economic disorder, lies three major factors: (i) a lack of structural economic reform/investment resulting in diminishing productivity, (ii) globalisation and technological destruction of jobs and (iii) two decades of progressively declining interest rates resulting in a global debt explosion to fund public services, private spending, GDP, asset prices and the illusion of economic good health.

These factors have combined to mutate into a wide-spread divisive social problem—income inequality. **The 21st century has evolved into a world of haves and have nots.** Those with income and/or capital borrow to increase wealth. Those without, borrow to survive. **When one was born now seriously impacts what life one can expect**. Boomers did well, others not so much. We are in a pickle, that neither politicians nor people seem prepared to confront. Content to kick the can down the road, **we are running out of road, reduced to simply printing money.**

Few affluent people want to give up what they have, much less pay higher taxes. Whilst an ever increasing number of often innocent low income households rely on government services to retain their dignity.

Rising asset prices, are not evidence of prosperity. Perversely they are an inverse function of the cost of money (**10 year bonds** to be discussed in our next issue). That is, when interest rates are high, asset prices are low. Savers are rewarded with high returns/low risk. Borrowers pay high interest rates from future income to invest in risk assets with volatile prices.

Reflecting back on our 3 root problems, it is not hard to see that when interest rates fall for decades and look like they will never rise, people respond accordingly and roles are reversed. Savers are punished by low returns and borrowers rewarded with lower costs and higher capital gains. Predictably then, ever since the early 2000s after 9/11 when interest rates falls were accelerated, **most people have borrowed more and saved less.**



You are looking at what happens over 20 years as interest rates fall.

Debt doubled before COVID and interest costs halved. Asset prices have followed debt. COVID has extended both to extreme levels.

How much lower can rates go from ZERO?

Be alert **INFLATION** risks may tip the apple cart.

Moving forward, let's acknowledge that **PRIOR to COVID-19**, most of the world and most people were deeply in debt. Then, COVID hits with jobs and incomes suddenly at risk. **RED ALERT.** In Australia, luckily being 5,000 kms from anywhere, Scomo hands out 100s of billions, Daniel Andrews steps up with 10s of billions. **ALL BORROWED**. Josh Frydenberg relaxes the "responsible lending" rules and tells banks to get out there and lend to home buyers to save the economy. Meanwhile the RBA reduces interest rates to 0.1% announcing it is not afraid of asset bubbles forming. Wow!

This perfect storm creates an economy sloshing in too much money, with too much liquidity seeking a home. Supply chain disruption in manufactured goods adds to the problem. Rising prices result, especially property prices and shares. Resisting the lure of easy gains, especially when everyone is on board is always going **to trigger a buying frenzy**. So we have one.

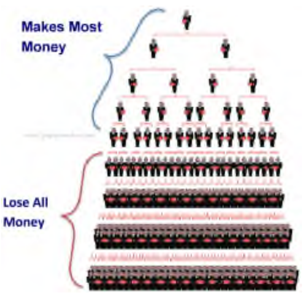
What is **TINA** you ask? Well when money earns NOTHING in a bank account or term deposit, **There Is No Alternative** but to withdraw the cash and invest in risky assets to generate higher income. This behaviour, mostly taken by conservative investors and typically towards the end of a cycle, means even **more money is chasing the same assets driving prices even higher**.

Property, shares, cars, collectibles and even bitcoin are on a liquidity wave that appears to be unstoppable. For now, let's all just enjoy the 2021 ride.

Pyramids And Ponzi Schemes

We hope readers find this next piece lighter in content, yet no less informative. In keeping with the current post COVID-19 speculative investment theme, we explore two traditional "get rich quick" schemes often conflated in every day speech: pyramid schemes and Ponzi schemes.

Every industry is built on understanding human nature. How people make decisions and why. When it comes to money, most people have a form of guardian angel on one shoulder that helps them to identify that when something is **too good to be true**, don't do it. On the other shoulder is a devil that sees the same offer as **too good to miss.** Occasionally, all it takes is the right words from the right person at the right time and bingo! We are irresistibly drawn to do something **we just know we will regret.**



Pyramid schemes are built on a network principle where a person at the top of the pyramid promotes a product or service to recruits for a fee, who are themselves required to sign up more recruits for a fee, and so on, and so on. The growing money pie is shared at each level, but always leads to the top.

The schemes usually fail because it becomes increasingly difficult to find new recruits/members to pay money and join the system. Failed schemes include the airplane game and many chain letter variants.

Not every pyramid scheme is a financial fraud. Multi-level marketing companies such as Amway, Younique and Herbalife amongst many, use a pyramid distribution model. However they are based on genuine product offerings designed to fulfil a customer need or want, not just sign up fees. The lure of these business models is that distributors are attracted by the notion of being "business owners" whose income is not determined by time like employees. Unfortunately, for most, the outcome is predictable.

Ponzi schemes are arrangements entirely different from pyramid schemes. They are based on the **"robbing Peter to pay Paul"** principle. Essentially, a promoter promises returns to investors, either dividends or interest, that are unusually high (e.g. 10% per month). There will usually be a somewhat plausible explanation justifying the high returns which will allay the concerns of any sceptical investor.

In reality, the returns payable to prior investors are funded from the principal contributed by new investors, as **there is no underlying business**.

Typically, once a scheme is seeded and initial promises and payouts are fulfilled, it is human nature for the early investors to spread the word about their investment savvy to family and friends. With evidence in place that the cash payouts are real, it is mechanically predictable that many new investors will be drawn into the arrangement in a manner that resembles a pyramid scheme. The only genuine similarity in the two schemes is that **the participants of both are blinded by easy money.**

Before readers convince themselves they are unlikely to fall victim to such transparent schemes, one would do well to be aware that modern well structured packaging of an old idea can be extremely convincing.

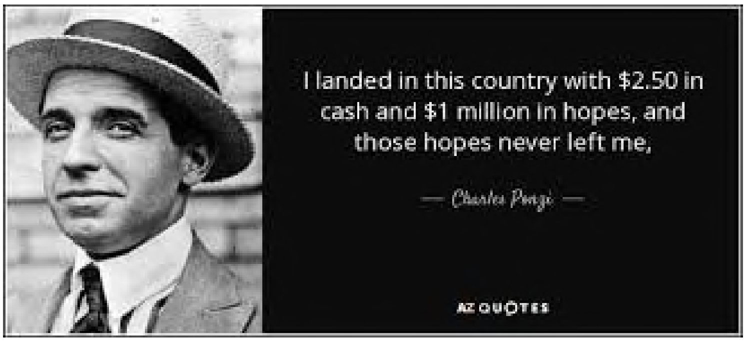
As recently as 2008, Bernie L Madoff a former Chairman of the NASDAQ was exposed for conducting a Ponzi based fraud for over 25 years amounting to US$64 billion! Madoff was renowned for his consistent investment returns over decades. Using undisclosed "strategies" his funds reported returns averaging 10.4% pa with surprisingly little volatility. **Investors received monthly printed investment and performance statements.** A feature of Madoff's scheme was its "exclusivity" to wealthy or prominent individuals such as Zsa Zsa Gabor, Kevin Bacon and John Malkovich, banks and charities (Stephen Spielberg's Wunderkinder Foundation). Exposed only as a result of the GFC banking crisis which froze his funds, Madoff, unremorseful was sentenced to 150 years jail in 2009. His innocent son committed suicide 2 years later. A financial sociopath, **Madoff's investment funds never traded in shares or securities.**

Meet Carlo "Charles" Ponzi (1882-1949)

Having read a little about the Ponzi scheme process, let's take a deep dive into the man after whom it was named (but not invented). It is 1919, in the post WW1/ Spanish Flu US euphoria. A time of confidence and rapid change, industry was getting back to work, exciting innovations in science and machines and many immigrants and new ideas were coming to America. A time when people saw **money being made all around them** and a cavalier approach was taken to both risks and returns. A time not dissimilar to today.

Charles Ponzi was born in Italy with an aristocratic heritage whose family wealth was long gone. He was devoted to his mother who as a child instilled in him high expectations to redeem the family name. He never forgot this. He attended university at a time when few could and mixed with the elite.

He was a complex character, a charismatic charmer with a decided taste for the good life. He was entrepreneurial to the core with big dreams. Leaving Rome on a ship bound for Boston, Ponzi had $200 to start a new life. By the time the ship landed, he had gambled and spent all but $2.50.



Undeterred, he quickly learned English while working as a waiter and soon moved to Canada being introduced to banking. Imprisoned for forging a cheque, then again for illegally assisting Italians to cross the border, he returned to Boston and after some years married, Rose, the love of his life.

Seeking that elusive get rich idea, he rented an office and there received a letter with an **International Reply Coupon (IRC).** It was a eureka moment. IRCs were a form of reply paid postage enabling people to write to family and receive a reply even where the recipient could not afford postage. Ponzi identified them as an international currency. With European currencies decimated, it was possible to buy $US5 of IRCs in Europe with only $US1. This lucrative risk free arbitrage was the plausible basis of Ponzi's plan.

Refused loans by banks, Charles believed he had a legitimate way to make big money. He just needed the capital. To raise it, he offered his a **50% return in 45 days** or **100% return in 90 days**. A week prior to maturity, Ponzi courteously wrote to investors to arrange a time for them to redeem their cash. Most reinvested and added more. Word of this deal spread quickly and within weeks, the Italian community, the wider community and even people interstate sent him thousands of dollars. Within 6 months, the cash inflows became millions with Ponzi opening 20 offices throughout the US.

Charles Ponzi had fulfilled his life's ambition. He enjoyed all the trappings of his success: the fame, the money, the house and the car. He paid passage for his mother to travel to Boston, first-class. It is considered Ponzi genuinely intended to convert his wealth into a legitimate business making good every promise to every investor . He donated large sums to charity and was exceptionally generous to all around him including his local community.

Suspecting foul play, the Boston Post put an end to the dream in August 1920. A front page story published after an interview with Ponzi's public relations manager saw a run on all the Ponzi offices exposing the scheme and its hopeless insolvency. Investors lost $20m and Ponzi was jailed for mail fraud. Consumed by success, **he had not purchased any IRCs.**

Following his release from prison, Ponzi headed a land swindle in Florida. He was later deported, then divorced, though neither he or Rose remarried. Moving to Brazil he worked with an airline, then later taught English and French. In 1949, he died in a charity hospital in Rio. At his bedside was an unpublished manuscript "The Rise and Fall of Charles Ponzi" - he had $75.