

# Rational Capital Management LLC



## **Annual Report to Clients**

For the year ending

**December 31, 2008**

# Rational Capital Management LLC

To My Valued Clients:

**2008 was a historically bad year. For a brief and fleeting moment, let's relive it...**

- January 11 – Bank of America announces it will buy Countrywide for over \$4 billion.
- January 15 – Citigroup announces it will write down \$18 billion in subprime losses.
- January 17 – Merrill Lynch announces it will write down \$22 billion in subprime losses.
- January 17 – Lehman Brothers cuts 1,300 jobs.
- February 14 – UBS announces a full-year loss of almost \$4 billion and an \$18 billion write down in its mortgage portfolio for 2007.
- March 11 – the Federal Reserve announces it will provide \$200 billion in emergency funding for banks.
- March 17 – JP Morgan announces it will acquire Bear Stearns for \$2 per share. Though the deal is later revised up to \$10 per share, it is still backed by a \$30 billion loan from the Federal Reserve.
- April 1 – UBS announces an additional \$19 billion in subprime write downs.
- April 18 – Citigroup announces an additional \$17 billion in subprime write downs and cuts 9,000 jobs.
- June 8 – Oil hits \$148 per barrel and the average national price per gallon of gas hits \$4.
- July 1 – In the ultimate acknowledgement that we are in a recession, Starbucks announces it will close approximately 600 stores and eliminate 12,000 jobs.
- September 7 – Fannie Mae and Freddie Mac go into government conservatorship, placing the liabilities of more than \$5 trillion in mortgages directly on the backs of taxpayers.
- September 14 – Bank of America announces it will buy Merrill Lynch for \$50 billion.
- September 15 – Lehman Brothers files for bankruptcy. At the time, it has net assets of \$26 billion. Shares close the day just above \$7, down from \$59 one year prior. Shares currently trade at 3 cents.
- September 17 – The Federal Reserve announces it will take control of AIG with an \$85 billion bailout package.
- September 18 – The SEC's temporary ban on short selling financial stocks goes into effect.
- September 29 – The Dow Jones Industrial Average falls 777 points, the largest single day loss in history.
- October 3 – The federal government passes the \$700 billion bailout package (Troubled Asset Relief Program).
- October 13 – The Dow Jones Industrial Average rallies 936 points, the largest single day gain in history.
- October 15 – The Dow Jones Industrial Average falls 733 points, the second largest single day loss in history.
- October 28 – The Dow Jones Industrial Average rallies 889 points.
- November 19 – The CEOs of the Ford, General Motors and Daimler-Chrysler fly luxury private jets to Washington to ask for a \$25 billion auto industry bailout.
- December 11 – Bernard Madoff is arrested for allegedly defrauding investors of \$50 billion.
- December 24 – Oil closes at \$35 per barrel and the average price for a gallon of gas drops below \$1.70.

Typing each line, I remember my feelings as the reports came across the wire. I particularly remember the market gyrations in October. It was a painful year for everyone. Let's have a moment of silence for 2008...and let's move on...

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## **Football and Family**

As a matter of principle, my father regularly disagrees with me just for fun. He has a nasty habit of calling me “homo economicus” instead of my real name. He calls me this because he is sometimes baffled by the level of rationality I use in my decision making process. Good investing, however, requires a calculating approach.

Recently, he sent me an email with the title line reading “You Will Absolutely Love This....” He was right. The email contained a link to a news story about a high school football coach in Pine Bluff, Arkansas who is bucking tradition because of his faith in the power of statistics.

Kevin Kelly, head coach of the Pine Bluff Bruins, almost never punts, almost always goes for it on fourth down, and almost always onside kicks. If you are not at least a casual football fan, let me assure you that each of these behaviors individually makes Coach Kelly an anomaly – put together, he is viewed as something of a heretic.

But this is not madness – it is all based on evidence. It is rational. If the Bruins have a fourth down inside of their own 10 yard line, they convert the first down more than 50% of the time. If they don’t and their opponents get the ball inside the 10 yard line, there is a 90% chance they will score a touchdown. But if they punt it away, the other team will still score a touchdown 77% of the time. Using purely objective measures, going for it on fourth down - even inside their own 10 yard line - is the superior strategy.

As for the onside kicks, the statistics also dictate the choices. The average starting field position for an opponent when they recover an onside kick is only 14 yards better than a traditional kick. And for those 14 yards, the Bruins get a chance of recovering the ball, which they do often enough to also make this a superior, non-traditional, and completely rational strategy.

So how did it all work out? Well, the Bruins lost their first game of the season this year. Then they won 13 straight *including the State Championship game*.

This story resonates with me for two reasons. The first is that you have to believe in the research, even when it goes against convention. Coach Kelly is unlike any other coach in America – but that is why he is a champion. He believed in the power of his research to reveal truths that were hidden from other coaches. On top of that, he had the willpower to institute those beliefs at a time when they bucked convention.

The second reason is that even the most rational strategies will not work every time. The Bruins lost their first game. And though my models have, on aggregate, outperformed their benchmarks this year, I am disappointed with the losses they suffered. But I am not about to change my investment philosophy because, like Coach Kelly, in the long term it is a winning formula.

## **Talking Heads, Prognosticators, Idiots**

During the year, I provided emotional counsel to many of you. One of the cornerstones to my unique brand of “investor therapy” is the requirement that you ignore the financial press. There are several reasons that I advise this. The most obvious reason is that no matter how you feel about the markets, watching the news will exacerbate those feelings. For example, when you feel bad about losses in your investment accounts and turn on CNBC to hear about some global financial institution blowing up, your initial bias is enforced, and your heightened emotional state invariably leads to bad investment decisions. (Though difficult to imagine, the same bias is possible in up markets as well, a-la 1999, when people were too happy.)

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Another reason to avoid the financial press is that the advice implicit in its reporting is often wrong. BusinessWeek recently published an article on the worst predictions of 2008. Let's take a look at a few of my favorites:

- **"I expect there will be some failures. ... I don't anticipate any serious problems of that sort among the large internationally active banks that make up a very substantial part of our banking system."** —*Ben Bernanke, Federal Reserve chairman, Feb. 28, 2008.* Right, if you don't count Countrywide, Citigroup, Bank of America, Lehman, UBS, Bear Stearns, JP Morgan, AIG, Fannie and Freddie.
- **"I think you'll see [oil prices at] \$150 a barrel by the end of the year."** —*T. Boone Pickens, June 20, 2008.* The new paradigm in energy pricing never came to fruition. Oil never reached \$150, and is currently trading below \$40 per barrel.
- **"No! No! No! Bear Stearns is not in trouble."** —*Jim Cramer, CNBC commentator, Mar. 11, 2008.* Six days later, on March 17, JPMorgan Chase announces it will purchase Bear Stearns for \$2 per share, backed by \$30 billion in Federal assistance. This deal was later revised up to \$10 per share, but holders of Bear stock were still nearly wiped out.
- **"A very powerful and durable rally is in the works. But it may need another couple of days to lift off. Hold the fort and keep the faith!"** —*Richard Band, editor, Profitable Investing Letter, Mar. 27, 2008.* The S&P 500 is down approximately 34% since March.

As an investment advisor, people often ask me my opinion on the markets. Specifically, people want to know whether the market will go up or down, or if there is a good stock to buy right now. Any honest investment advisor should answer "I don't know" to these types of questions.

There are good reasons to dislike such inquiries. Whether my prediction is overly optimistic or pessimistic, it is almost certain to be wrong. More importantly, making such predictions undermines my investment philosophy.

There are things investment advisors can control, and there are things that they cannot. The short-term performance of the market is not something I care to predict because it is out of my control. Over a long time horizon (10 year or longer), statistics dictate a somewhat predictable range of market performance. But over long time horizons the more critical elements in a successful investment strategy are investment philosophy, asset allocation, and the consistency of your commitment.

**With that in mind, it is often the best strategy to expect modest economic performance every year.** Modest expectations lead to modest, budget-oriented living, consistent savings, and ultimately financial success. Some years will be like 2008, and you won't even get modest performance. In those years, you may even have to dig into your savings to stay afloat. But if you lived within your means and saved in the good years, you can weather the storm. Other years will be like 1999, and you will get mind-blowing performance. Those will be the years where you are truly rewarded for your consistent saving and rational approach to investing. In the end you will have experienced the highest highs and the lowest lows, but you will be rewarded for your consistent and rational approach.

For what it's worth, the talking heads are expecting modest performance for 2009. Because the stock market leads the economy (that is, the market will go up before the unemployment and GDP *actually* improve), the talking heads are predicting modest market gains in 2009 because they expect economic stability in 2010. Will it actually turn out this way? Who knows?

## Honestly, who cares?

Live within your means. Believe in your plan. Be consistent. Invest rationally. Do this year in and year out and you will achieve your financial goals.