

The Past Doesn't Count

1. A Futile glance backwards

No axiom of micro-economics is more frequently misused than the statement "sunk costs are no costs". The majority of book-keeping concepts are nothing other than the presentation of accrued costs. Financial analysis is based largely on past results. In industry, what is measured is the "return on investment" - the profitability on accrued costs - and the investor (and often not only he, but also his advisor) compares the success of his investments to their acquisition prices. In other words, past expenditures are judged by their present positions.

And yet, contrary to the crushing crowd of those fixated on the past: past costs are no costs! One who disregards this sentence consequently uses an unsuitable compass. Hopeless projects will be followed up because "one has already invested so much". Nothing is more painful than to have to realize one's losses. This admission forces an owning up to the faults of the past and such acknowledgements tend to weaken self-esteem. As if it would be possible to make past mistakes disappear by concealing them, or erasing them, or just not realizing them. The exact opposite is in fact the case: He who does not admit to his errors, does not make them disappear, but rather will end up sitting on them in the future. Many investment relics would not have happened had timely courage been summoned to make history out of the past. This holds not only for buildings and construction, but also quite particularly for the components of a portfolio.

In an era which has been influenced by the worldwide, constant, low interest rates, and which is characterized by extremely sensitive valuations of each and every change in assessment of future developments and prospects, the ability to take leave of past judgements is an absolutely crucial quality.

The prerequisite for this lies, however, in a somewhat more differentiated opinion as to how to deal with the past, and above all, how one is to judge the so-called "mistakes" made previously.

When this Investment Commentary touches upon historical-philosophical domains out of necessity, then it will always be against the practical background of the economically correct handling of investments which, although stemming from the past, let their present value be derived from the constancy of future returns only! A deeper treatment of the relationship with the past involves not only this very practical side but also a social dimension. As will be demonstrated, these social dimensions will not be irrelevant for the investor. The opposite is true.

2. The Biased View Backwards

It could well be that with the end of the 20th Century close at hand, the past is being reflected upon with special fervor. And not only reflected! Even more, the past must be digested. The choice of words emphasizes that which, up to now, apparently has been missed, misunderstood, suppressed, erased, hidden, and implies a social process of re-rationalizing and cleansing of conscience and mind. The professions of the historian, archivist and auditor are booming.

The spirit of the times takes a glance backwards. One could quietly hide this away with the justification that it is only a temporary phenomenon, grown out of this wave of conspicuous housecleaning, and not from the dangers which should particularly make the long-term oriented investor suspicious.

We Europeans are amused to note some of the excesses of the American legal culture in liability cases. We think it strange that millions have to be paid out when a fool falls of a ladder because the last rung has no label indicating that it is the last rung and one should not try to climb higher. The conti-

mental hair bristles when a homeowner is condemned to pay compensation to a thief who fell through a glass roof during a burglary attempt. What really puzzles us, however, is the fact that the wave of "working out the past" is rolling over our history in exactly the same way.

On closer inspection, this modern way of researching history deals not only with the account of what has happened, but also concerns the acquiring of a foundation in order to *correct history*. What makes up such a scheme?

- a) There must exist a "victim" or a group of "victims", who are sufficiently pitiable enough in order that public and moral opinion are almost compelled to stand on their side,
- b) a target must be located, which on the one hand is sufficiently well heeled and on the other hand enjoys little open sympathy. (The "rich" are a priori perfect targets, as long as one is not dealing with a film star or a sports hero),
- c) the target must be limited in his ability to negotiate, so that he most likely will be prepared to compromise and settle, and
- d) the matter must be "newsworthy", in order to awaken the general interest of the public as well as that of the media.

Instead of an extensive, indifferent, and perhaps somewhat boring, pedagogic historical science, the modern coming to terms with the past follows a legal purpose, with the clear goal of changing or settling old scores.

3. The Past as a Pretext to Redistribution

The greatest threat to free enterprise, namely expropriation under the heading of naked class struggle can, in principle, rightly be assigned to the past. This doesn't mean that the sociopolitical concepts of socialism do not necessarily govern the heads of the many old-68'ers in politics and society. Only: The class struggle as such is no longer drawing huge crowds. The philosopher Karl Popper (1902-1994) suggested in his scientific theoretical work that incorrect concepts cannot be eliminated by proving their inadequacy or inaccuracy; as a rule they vanish because no one is showing an interest in them anymore. This could certainly apply to the end of socialism as well: The phantasm of the

"classless society" has been proven wrong thousands of times in theoretical works. But it only began disappearing when it was found to be hardly newsworthy any more, there is no way a "story" can be reported.

There are now countless indications that in place of plain socialism and its related ideas of redistribution, a new style of "coming to terms with past" has appeared. Because one thing is clear: Arising from the effort to overcome the past, a media-suitable and satisfying "story" is now being made which fulfills the needs of the broad public.

New players are now participating in the expropriation "games" which are based on the perceived injustices of the past: The state in its sociopolitical roll as taker and giver is not making an entrance, however, rather "Non-Governmental Organizations" (NGOs), their foot soldiers being an American-style, rank and file of attorneys. Governmental institutions such as the courts and supervisory boards are used in the campaign, and if necessary extraordinary authorities will be created: fact-finding committees, historian commissions, which will be equipped as much as possible with special powers.

Under the influence of the media, all social sectors today are likewise becoming instrumental in these crusades. They are compliant tools of this legal dealing of the past as a result of the desperate search for newer and newer stories. What then could almost be superficially interpreted as a conspiracy of the "evil" media, turns out to be a consequence of the savage competition for better viewer ratings and higher market share.

Unlike the relatively uniform, and even to a certain degree predictable redistribution by means of taxes which employ patterns followed by the state, the reconciling of the past strikes out selectively, brutally and is difficult to forecast. The future targets still fancy themselves in the greatest of safety, and unexpectedly they will find themselves facing huge demands and be exposed to media drum fire. More and more in the future, an intelligence gathering element, which will assess the probability of attacks from coping with the past, will have to be part of strategic investment consulting and counter-strategies against such attacks will have to be developed. These intelligence service components will also be important for investors contemplating investments in potential targets.

Banks, insurance companies, industrial corporations, wealthy individuals or foundations, and so forth: Who doesn't have some actual, some possible or some potentially embarrassing "skeletons in the closet"?

4. Working with the Mistakes of the Past

There is no doubt that mistakes are constantly being made. One miscalculates, one forgets, one steps over the boundaries of law as well as those of good manners. Some errors are immediately apparent and must likewise immediately be corrected. Other blunders hide with time behind the veil of gradual forgetfulness, with the danger, however, that conclusions will be built on mistakes, and that later correction of these mistakes will become more and more costly, for the transgressor as well as for the trusting third party.

An essential quality or characteristic of dispute settlements under the rule of law is that for various transgressions, laws exist and that transgressors can be taken to court. However, the greater the length of time to the incident, the more delicate a correcting intervention of the state will be. Why? Because time has not stood still since the event happened. In the meantime, property that was once owned, for example, has been sold; innocent and honest third parties have built homes on it – how should a correction be made? Whose rights should predominate – those of the historic owner or those of the acquirer in good faith?

The question is so tricky because a one-sided partisanship in favor the historically entitled would throw society into an immense chaos. If entitlement would be awarded on an historical basis, the whole of North America as well as the furthest corners of Latin America would presently be unjustly owned. Reasoning it to the end, there would hardly be a spot on this earth that had not at some time or another belonged to someone, and that had changed hands in a less than fully legal or moral way.

In coming to terms with the past on a legal plane, which is now occurring more and more frequently, attempts are made to intervene in ownership relations. Any maligned descendants, respectively, their NGOs are declared as being entitled and they aim for the property of their targets, which in the best case are the descendants of those who

made the original error, but more often are merely trusting third parties.

Even if a historically well-founded legal right appears legitimate, it often proves impractical and sometimes even dangerous. Dangerous because one specific idea of justice is placed above the interest of the social order of peace. Our market-economy is built upon a such a social peace order. It only recognizes principally contractual ownership and ownership through inheritance; only in exceptional and emergency cases does it resort to the pressure of the market-economic system, namely then when the law must be upheld or an execution is called for.

There is good reason why the market oriented system and its legal framework include safety barriers against historic claims. We recognize the institution of possession of property by prescriptive right, or that of the limitation of rights. Exactly from these legal institutions flows the peace order that is the basis of modern society; the legal profession's mastering of the past was foreseen. An exaggerated sense of justice can cause discord. The intervention in the peace order from an apparently higher standpoint of historically well-founded legal rights hits our system exactly like that of the concept of the class struggle of old.

The other problem concerning the correction of mistakes of the distant past lies in the absoluteness of the judgement of whether there had been an error at the given time or not. Observed from a distance the world and its history appear quite distinct. Everything looks as if it had to end up as it had turned out. The outcome of the Battle of Waterloo seems just as consistent and logical as the end of the War in Vietnam, and obviously everyone already knew in the 70's that the Soviet Union's days were numbered.

With exactly this deterministic attitude, the historian commission ("Bergier Commission") went to work in this country, with the order to "refurbish" the past of our country prior and during World War II. In a most thrilling argument with Economics Professor Lambelet of Lausanne, concerning the judgement of the gold trading of the Swiss Central Bank with the German Reich, they openly admitted that they, for instance, cannot simply understand the situation of uncertainty to which the Central Bank of a landlocked small nation is exposed, when it

must maintain the convertibility of its currency. The legalistic re-writing of history cannot use situations of uncertainty, because they would place the clarity of the mistakes in question, and the result would be neither newsworthy (the media needs a clear offender), nor would it show enough potential for a correction of the error, i.e. redistribution.

5. The Rascals in the Archives

He, who sits daily in front of the screens of the financial world and earns his bread from the constant ups and downs of currencies, interest rates, and share prices, he knows situations of uncertainty. Not for a day, nor an hour, nor a second, is there the certainty that *just now* the change in trend has come; whether or not – just now – the moment has come to rename former considerations as mistakes. He, who constantly lives in uncertainty, he knows above all how relative the term “mistake” is.

The undisputed clarity of all mistakes made in connection with national socialism now leads us to understand that the legal writing of history expands to cover historical events, which are by far less clear, and are placed in a context of certainty or a “one-should-have-known” situation, in order to reach a clear judgement. And with these givens, the historians and the auditors now storm the archives, which have been opened to them most compliantly by state decree. From their safe standpoint, they judge the highly-paid employees, and what the people have done or failed to do decades ago, which certainly will be subsequently seen as “wrong”, very much being proven very right. People who, above all, had to live daily and hourly with uncertainty, things that the rascal of today has no idea about.

An end is not in sight. After the refurbishment of history in connection with World War II, something similar will be arranged with reference to the relationship of Switzerland with the DDR. And as soon as there is a next suitable topic, than historical refurbishing will again be put into action. And by no means does this happen only in Switzerland. South Africa, Chile and the Congo are already in the refurbishing pipeline. Who knows whether or not one day that certain activities and failures in connection with Kosovo will be seen in a new light? And of course, again and again with the same incor-

rect preconditions, which arise from the non-existence of situations of uncertainty.

6. “Hindsight” as an Illegitimate Perception of the Past

Now one must note that the completely nonsensical acceptance of the nonexistence of situations of uncertainty is not totally strange only to the historian commission, but that something similar is rumored to exist in investment and consulting circles. The retrospective glance to, say, the price developments of a share or of an index allows, from the comfortable observation point of the present, the realization of everything that could have been done differently, under the assumption that one had known then what one knows now. Whoever speaks in absolute terms about “mistakes” with reference to decisions made in uncertainty, exposes himself basically as ignorant and unfair. The question could be, at the most, whether a specific decision had been *acceptable* or not, acceptable to the then situation of uncertainty.

Our decision in the Fall 1998, to maintain the share quota in spite of massive and (from the view then) dangerous financial market turbulence proved to be, after the event, as “right”. Basically the decision was *only acceptable*, and it would have still remained acceptable, if in the meantime the correction upwards didn't occur; yes, when the prices once more would have plummeted 30% into the cellar. In dealing with risk and returns, no other decisions than “justifiable” and “non-justifiable” exist.

At each client meeting during the last few months, at which we have looked back at the past year, we have tried to give the above knowledge some transparency, implying a certain degree of modesty when a development was “rightly” forecast. However, it is also a call for more reserve and decency, when by all justification a decision subsequently turned out problematic, contra-productive and “false”.

The same restraint must be demanded from historians. One must even designate it as their duty to allow uncertainty situations of the past be intellectually revived again. And not to take the actual course of fact on the pretext that the uncertainties never existed.

7. How the Past still Counts

Modesty with respect to previous performances and restraint in the judgement of one's eventual poor showing are mirrored in the understanding of one's own imperfection in coping with the present. When such an insight is missing, then working with the past is somehow illegitimate, and results are insignificant. This applies to historian commissions as well as for people who must make economic decisions.

Only when one is aware of one's own imperfections in the light of the uncertainty of each situation, he can put away "mistakes" of the past with the necessary distance. And only with this taking distance is it at all possible to live up to the rule "sunk costs are no costs" in its full meaning: to realize losses, to separate from disappointing investments and at any moment be able to look to the future.

This look to the future would not be possible without knowledge of the past. In this sense of course, *the past absolutely counts*. Involvement with it is more than justified from three aspects:

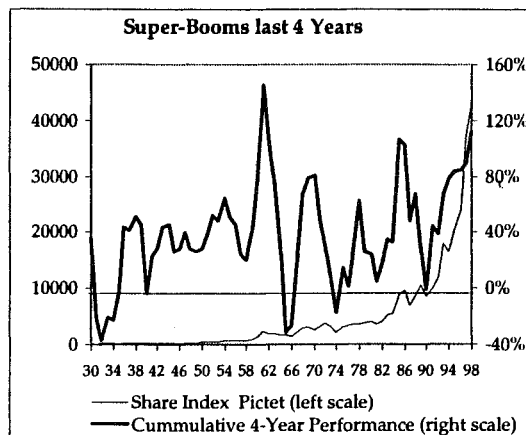
- a) Made or duplicated experiences, by analogy allow for future developments to be surmised.
- b) Theoretical concepts (as economic models are) can only be examined for their practical content with data from the past (Empiricism).
- c) Long-standing empirical values can be projected by extrapolation in the future.

The meaning of these three manners of utilization of the past is explained in some examples.

First, a glance at the extreme super-booms in this century shows an amazing regularity: They do not last longer than four years. It is as if the stock market at some time becomes breathless, and after four years (at the latest) accompanied by long-standing price increases, the euphoria slowly dies. What follows is not necessarily a crash-like fall, but at least a very definite reduction in the increase of the index values.

Of course one can obviously find a number of arguments which dispute the empirical content of this pattern of experience. The basic conditions were completely different at each of these booms. Neither the interest rate, nor the currency, nor the business cycle

situation can be compared to each other. One can also question the number of statistical observations. And in the end, one can also say that there are no rules without exceptions.



Source: Pictet;

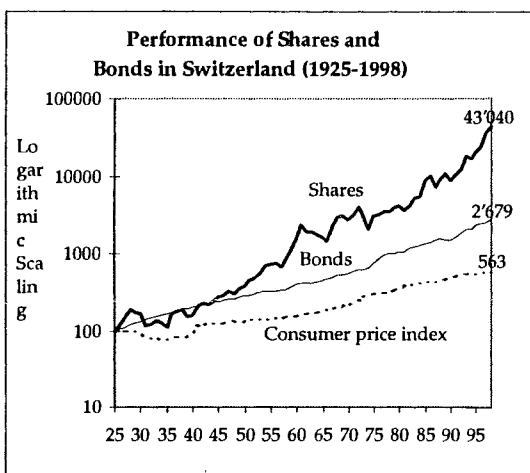
another rule which says that trees don't grow into the sky. A typical example from the experiences of the past! We rather tend towards somewhat "more economically" based analyses. In the case at issue, for example, the crab-like movement of the European stock markets, which has been observed for some time, can be explained by interest rates which cannot drop much further, with earnings margins that are under pressure, and correspondingly, narrowing profit outlooks as well as risky prospects in exports. As always: At least in our emotional decisions, we will always reach back to *experienced or traditional models* of the past. And possibly the "Farmer's almanacs" are not all that wrong.

Secondly, the past serves as a breeding ground for *empirical scrutiny* of theoretical speculations. The science of economics works with models which are built upon specific axioms. In ever new combinations, the laws of logic (that is, mathematics) construct ever broader and higher frameworks, which ultimately serve the explanation and the prediction of economic developments. Each theory has its weaknesses and therefore must be put through a reality check. This is empiricism. When we, for instance, have derived theoretically (see Investment Commentary No. 191 of December 1998) that due to very low interest rates, that volatility must remain relatively high, that therefore volatility and interest rates are negatively correlated, then this theory would have had to also be documented; this a procedure which can be very

time-intensive and therefore must be dropped for an Investment Commentary due to time factors. (The empirical evidence has been produced at a seminar in the meantime.)

The past ultimately also serves to enable that shorter-, and above all, longer-term developments can further evolve in the future. On the condition that, other than time, nothing essential changes (one says of this: "all things being equal"), we proceed from this assumption that a trend as well, will not change. This is *extrapolation*.

If we, for example, propagate a share investment as the long-term, unequivocally superior investment form, our good conscience is then based, to a greater part, on an extrapolation of average value of return. Swiss shares increase in value about 10% p.a.

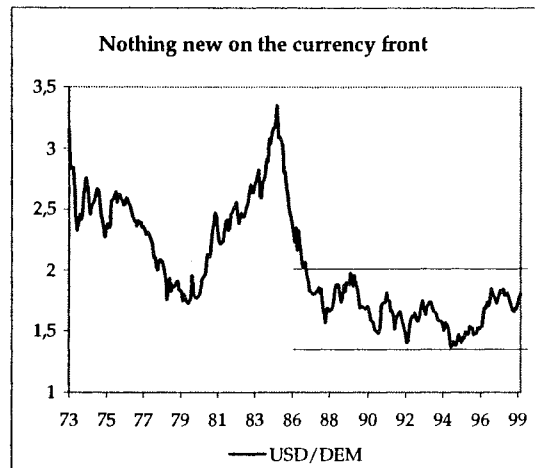


Source: Pictet

The annual growth rates, however, vary greatly, and lie between -30% and +60%. Indeed: That we dare to extrapolate without much further ado, is explained moreover and above all, also economically. The risky surrendering of one's own funds *must* be more profitable than a foreign currency interest yield, for otherwise no one would be prepared to offer one's own money. Ten percent seems to be about right.

In a similar way our (relative) calmness concerning investments in the US Dollar can also be explained. Since the 1960's, there have been two major deflationary cycles of the Dollar against the most important European currencies. The one devaluation followed the end of Bretton Woods, the other after the large revaluation phase at the beginning of the Reagan era. For the past 12 years, however, the development of the US Dollar

against (for example) the German Mark has been moving in a quite narrow corridor. This, in spite of record high American budget deficits, followed by just as record high current account balance deficits.



Source: Bloomberg;

has therefore proved itself justified, if not even more fundamental in explaining an actual change in direction than budget and account balance deficits. The introduction of the Euro and, through it, the possible occasional replacement of the US Dollar as the World Reserve currency, could result in such a change of direction. In the meantime, it has now been shown that the economic growth and the productivity increases in the USA are so robust, and the corresponding values in Europe are so anemic, that the Dollar can continue to remain firm. The extrapolation can therefore continue.

8. Every Past was also at Some Time a Present

In sum, it is postulated, that one should have a differentiated relationship with the past. The title of this Investment Commentary "The Past doesn't Count" is relevant in this sense and should be understood as a small provocation to contemporaries totally saturated with a longing to remodel and transform. Gain experience, learn from mistakes, repeat successes, recognize behavior patterns and long-term trends, bring empirical evidence: Yes. The past to be misused as a pretext for correction of the present, to eliminate the uncertainties of earlier times through the certainty gained in the meantime through factual knowledge: No. He who navigates more or less modestly through the present, because he recognizes his very limited abili-

ties to forecast and shape the future, will also practice discretion towards earlier generations.

But not only this: He will also be more tolerant to "false" developments in his own personal sphere of life. He will know how to appreciate appropriate decisions, if the development did not go according to plan. And also, it will be easier for him to take leave of past decisions, to realize losses, and to accept "sunk costs" as definitely lost.

With somewhat more composure, he will then also be able to accept the pompous success stories of others, which they have tried to prove through backtrading, what superior brains and what a lucky hand they had in their past investment decisions. If they only could know how little is based on true ability, and how much is pure coincidence!

Neither fatalism, nor a big-mouth, a doermentality, but rather *composure* is probably that quality which stands at the beginning and at the end of every successful investment activity. It should accompany us through the continuing very volatile markets in the near future.

KH, 16th April, 1999