



The \$7 Trillion Dollar Solution

What the Fed's strategy means for an index investor

It's financial recovery season. No matter how closely you watch, it's impossible to clearly see all the players and plays aimed at revitalizing the economy and securities markets. With the Treasury, Fed and FDIC operating through approximately 30 different programs that have spent or pledged more than \$12 trillion, no scorecard is big enough to track it all. So if you can only focus on one player in this complex game, make it the Fed. Its work is the key for index investors. Here's why.

The Fed controls

No entity controls the domestic economy or markets, but the Fed does control the most important price in the world – the price of money. The Fed also directly influences the *amount* of money and the *availability* of money in the global banking system. Price, amount, and availability of capital – or the lack thereof – shaped the financial crisis and will shape its reversal. The Fed has embraced its rarely used power as the lender of last resort, and has expanded it into a \$7.4 trillion enterprise. That's a program bigger than half of the entire US economy. These are indeed unprecedented times.

If money makes the world go round, the Fed is in charge of rotation. It is orchestrating not just a flood of money, but a flood of cheap money. The supply element is called “quantitative easing.” And by cheap we mean very cheap – a Federal funds rate set at close to zero. The scale of its efforts is remarkable. Consider, for instance, its funding of commercial paper (\$1.8 trillion available, \$240 billion spent) and purchase of Treasury and mortgage securities (\$1.55 trillion). Through these and other liquidity programs, and the commitment to cheap and abundant money, the Fed is taking bold steps to try to restore the free flow of credit to the capital markets.

The Fed clarifies

Most investors would admit that until recently they didn't know much about the Fed. But we've learned more about it in the last nine months than perhaps in the last nine years. Chairman Ben Bernanke, appointed by President Bush in 2006, has publicly committed to more transparency by the Fed, and we feel has delivered on that promise. We can't know if the Fed's moves will work exactly as planned, or when, but the Fed's open door policy eases some of that empty feeling of uncertainty and fear that we believe drove some investors out of the market in recent months. Without Bernanke's calm explanation of the Fed's plan and actions, we think many more investors would have panicked and fled.



The Fed calms

Transparency is especially important for index investors. Because we don't try to time the market or jump from sector to sector, what we need most is the sense that the markets are operating rationally – that there is some connection between the market price of securities and their real long-term value, that what you see is what you get. Even with the climb from the recent market bottom, many are not feeling great about market performance, but with the sense that the market is operating rationally – or at least headed in that direction – we think index investors are more likely to stay invested, which we believe is the only way to participate in the recovery, whenever and however it may play out. In addition to its price-setting role, the Fed – along with other government entities – has stepped in as an umpire to keep the game organized and fair. By enforcing and explaining the rules, it appears the Fed has helped to calm the markets.

The Fed normalizes

Index investors don't try to beat the markets. We seek to match the market returns of a broad range of asset classes, and by adjusting our allocations to these asset classes, create portfolios with risk and return characteristics consistent with our financial objectives and tolerance for risk. It is an approach we consider elegant in its simplicity, as over long periods historic returns are fairly consistent, although they may vary considerably year to year.

The last year reminds us that performance is never guaranteed, and that predicting short-term returns is foolhardy. However, over time we fully expect securities to return to their historic performance patterns as fundamentals return to historical norms – stocks delivering higher, more volatile returns, and bonds lower returns that vary less. Despite the pain today, we expect strong businesses to survive, grow, hire, pay dividends, innovate, merge, acquire, create new technologies and spawn new industries. The current moves by the Fed that make it easier for businesses, individuals, and municipalities to borrow foster a return to the fundamentals that moved the Dow from 100 eighty years ago to its current level.

The Fed acts

On Wednesday, February 28, 2009 Fed Chairman Bernanke testified before Congress that he would do “whatever it takes” to end the credit crisis. These are important words, a clear statement of intent and action meant to reassure banks, lenders, borrowers and investors around the world. As indexers we don't predict markets but we are heartened by the actions and clarity of the Fed. We can't know when things will be back to “normal,” if such a thing even exists, but we can be

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certain that cheap money, and plenty of it, is available to lubricate the economy, and will be for some time. And if more steps are needed, the Fed appears ready to act.

As the recovery continues, keep your eye on the Fed. We are.

John Osbon
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For further reading:

The Federal Reserve Bank of Boston President, Eric Rosengren, has recently written clear and cogent articles:

On the causes of the financial crisis:

<http://www.bos.frb.org/news/speeches/rosengren/2009/041509.htm>

On potential solutions:

<http://www.bos.frb.org/news/speeches/rosengren/2009/050509.htm>

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