

Austrian School for Investors – Austrian Investing between Inflation and Deflation

- With a preface by John Hathaway -

The Book

Madness seems to reign over the financial markets and many investors are driven by delusions and anxiety. Many feel that the world, and in particular the financial markets, are exposed to radical upheaval. Do conventional investment approaches provide an appropriate armamentarium in order to stand one's ground in the financial markets of tomorrow?

The Austrian School of economics evolved in the 19th century as a liberal research program, independent from the totalitarian ideologies of Nazism and international socialism that predominated at that time and had also a determining influence on social sciences. **Due to their independence from the interests of politics and banks, Austrian economics has ever since played a subordinate role.**

In particular, the monetary theory and the business cycle theory provide a crucial understanding of the major financial crisis of the past and the chaotic state of the financial system nowadays. There are signs indicating that mainstream investors will be caught off-guard in the years to come and that the Austrian Investing paradigm will prove itself indispensable.

This book guides savers, professional investors and financial advisors through the financial earthquake zone between the tectonic plates of inflation and deflation. **For the first time, renowned authors show how Austrian Investing works in practice.**

The Authors



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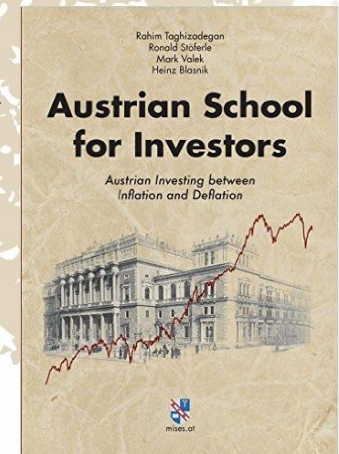
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Bibliography

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"The Austrian analytical framework is not a prescription for short term investment success [...] However, it does provide a foundation for sanity in the midst of mass delusion." – John Hathaway

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The Austrian School of economics evolved in the 19th century as a liberal research program, independent from the totalitarian ideologies of Nazism and international socialism that predominated at that time and had also a determining influence on social sciences. Due to their independence from the interests of politics and banks, Austrian economics has ever since played a subordinate role. But many among its scientific contributions have – even though being made quite a long time ago – an enormous explanatory power for the world today. In particular, the monetary theory and the business cycle theory provide a crucial understanding of the major financial crisis of the past and the chaotic state of the financial system nowadays.

What distinguishes Austrian economics? According to Willem Buiter, the research approach of mainstream economists at best consists of “self-referential, inward-looking distractions”. As the supreme scientific discipline of modern government, economics is likely also the most corrupted of all scientific disciplines. On the contrary, Austrian economists have been liberal and anti-totalitarian – they examined economic phenomena in a value-free manner. Their approaches base on four methodological pillars: First, individual human beings are the core unit of the economy. Second, subjectivism refers to the fact that there are no objective values but that individual valuations and preferences matter; prices are a result of these individual valuations. Third, marginalism, a concept that has also entered conventional microeconomics, says that only an additional unit’s value matter for individual trade-off decisions and hence for prices (e.g. water is an essential good, but we are unlikely to pay high prices for it in normal circumstances). The final main pillar is realism, as social sciences deals with social phenomena in the real world – interdisciplinary approaches appear to be more fruitful for studying reality than the excessive employment of mathematical methods.

In the Austrian view, there is hence no alchemy to produce wealth: determinants for the creation of real wealth are entrepreneurship, appropriate risk taking and capital accumulation. High returns can never be obtained – at least in the long term – without exposure to a commensurately high risk. The attempt to create wealth by printing money cannot work, but it distorts the economy’s capital structure instead and creates a “prosperity illusion”, as there is some nominal, quantitative growth. In fact, a dissolution of the economy’s long-term foundation, an increasing focus on the short term and a decline in quality consciousness can be observed nowadays.

As the economy is driven by the actions of uncountable individuals, actions that are in turn result of their subjective valuations, the future is uncertain. Therefore Austrian economics tend to very careful about prophecies. Nevertheless, their ability to anticipate crisis has been outstanding in the past. Generally, they regard statistical methods that extrapolate time-series data from the past to the future as inappropriate for forecasting purposes.

Austrian economics is also unique in its ability to answer the fundamental questions like “What is money?”, “What are interest rates?”, or “What is inflation?”. Money has different functions: a means of exchange, a means for saving, a means for measuring values. However, nowadays there is hardly any money that performs well in all these functions. The money produced by the state, namely currencies, might be suitable for exchange, but inappropriate for saving and measuring value. This has on the one hand its precondition in 1971 when the gold anchor was abandoned – since then currencies rest solely on confidence in the state and the banking system (and they lose their values when confidence is lost). On the other hand, total money supply is not controllable by single authorities, as in the fractional-reserve banking system additional fiduciary media is created *ex nihilo* by extending credit. Hence, as there is no sound money available nowadays, even hoarding becomes a matter of speculation.

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As both central banks and private banks contribute to the production of money, there is no uniform force of inflation or deflation. The commercial banks have become more reluctant to lend since the financial crisis, as they have been undercapitalized, need to fulfill the Basel III regulations and still need to recover. As credit takers are more and more over-debted, they are more reluctant to borrow. This has created enormous deflationary pressures. But falling prices would be a disaster in the modern monetary system, as it would increase the real burden of the debt and hence cause debtors to become unable to repay the credits, causing a spiral therewith. Consequently, central banks all over the world try everything to create inflation: zero interest rate policies, Quantitative Easing, Operation Twist, Currency Wars, Forward Guidance etc. These increasing forces, which have caused massive asset price inflation so far and can anytime break through to consumer prices, are captured by the metaphor of “monetary tectonics”.

The inflation efforts by the central banks distort, however, the production structure of the economy. In an advanced economy, the number of capital goods increases strongly, and production processes become ever longer and encompass numerous stages. But capital accumulation requires, as Ludwig von Mises put it, “apparent sacrifices”: more savings mean less consumption now and more consumption in the future. In a free market economy, interest rates would reflect people’s preferences of how to distribute their resources on current and future consumption. Accordingly, only those investment projects would be triggered that appear to be lucrative and worth sacrificing current resources for. With low interest rates, however, central banks try to stimulate capital accumulation without a change in behavior (in fact, incentives to save are actually reduced). More investment projects are hence set into motion than can finally be finished with the resources available. As capital formation means transforming resources into a concrete, irreversible structure, that requires time, and the lack of real resources becomes apparent only after some time; and the malinvested resources are lost. Then a process called “recession” is starting, where debt is liquidated, bad structures are broken up, bad companies go bankrupt and the economy reorganizes itself. As this process is fruitful only in the long run and painful in the short run, (monetary) politics tries everything to prevent a recession, therewith postponing it and making the underlying problems more severe. Austrian economists regard these kind of policy interventions as the cause of business cycles.

Value investors who don’t understand monetary developments nowadays suffer from credit expansion due to calculation errors. In the current environment, inflationary and deflationary forces massively gain momentum, increasing the likelihood for extreme scenarios. Ludwig von Mises put it in the following way:

“An inflationary policy can only be continued as long as the opinion that it will cease in the foreseeable future still prevails. Once the conviction that inflation will no longer come to an end has become entrenched, panic breaks out.”

Both hyperinflation, which goes in most cases hand in hand with a breakdown in government financing, and hyperdeflation, which arises with the write-off of book values and the destruction of balance sheets, price declines and mass insolvencies, might occur anytime. Neither a stagflation is unlikely. A way to “rescue” the status quo and to transfer the problems to the next higher level might be the introduction of Special Drawing Rights (SDRs) as a global currency. Generally, if things become more dramatic, investors will probably be exposed to a more severe financial repression – that are economic policies in which governments and central banks are using capital controls and regulations to distort asset prices in a targeted manner.

These diagnoses are the foundation of the Austrian investment philosophy. As the future is unforeseeable, one has to get prepared for all possible scenarios, using the diversification effect of a portfolio. Investment is an entrepreneurial activity: it consists of taking risks due to uncertainty with the aim of future value creation for the benefit of other people. Hence, the decisive entrepreneurial question is also equally relevant for the investor: What will people need

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tomorrow? **A good investment strategy hence is to transform income into wealth and to choose, build up and maintain those assets that will be able to generate income later.** This should be undertaken with the lowest possible debt in order not to suffer from a 'debt boundary'. Hence, hoarding – which is the retention of liquid funds – is an important prerequisite, as it ensures the capacity to act and avoids selling pressure. In a broader context, also value-oriented consumption, value-oriented endowment and value preservation belong to the Austrian investment spirit. A rough formula, or philosophical portfolio, can be deduced on how wealth is sustainably invested: 30% in liquid hoards, 30% in capital (e.g. machines, tools, shares in companies, rented out real estate), 30% in durable consumer goods (e.g. owner-occupied real estate, art, high-value appliances) and 10% in endowments (e.g. shares in enterprises for charitable, scientific, peace-promoting, cultural and environmental purposes). In the best case, wealth accumulation will become a long-term habit, which allows one to sleep well.

As a general rule, capital accumulation is likely to be done successfully in an area where one has more insights than the broad mass – investors should not leave their decisions to others and they should understand the things in which they invest. It also appears reasonable to diversify the risk geographically, meaning to build up some wealth outside of one's country of residence. For a good portfolio, four rules can be set up:

- (1) A good growth rate can increase the value of the investment over a long time period, without taking undue risks;
- (2) Avoiding large losses;
- (3) Focus on real returns – inflation must never be ignored when evaluating returns;
- (4) The proportion of gold should be roughly equivalent to the expected probability of the occurrence of extreme scenarios.

An interesting portfolio strategy is Harry Browne's Permanent Portfolio that is designed such that it is prepared for any possible economic environment. It consists of gold, cash, stocks and bonds, with a weighting of 25% each. Such a portfolio offers long-term stable returns (with a reduced volatility) and doesn't require any specific timing decisions, nor much management.

For Austrian investing, the classical criteria of value investing are relevant (e.g. the criteria presented by Benjamin Graham). In addition, Austrian investors look for enterprises with strong debt metrics, because in recessionary periods companies with strong credit ratings have room to maneuver independently of external capital providers. Also a high value orientation in form of a high dividend yield is preferable as it provides substantial cash flows and reflects the direct return from the associated investment. Valuable patents, brands and production techniques as well as fixed assets of great long-term value and low price-to-book values influence the attractiveness of an investment.

To conclude, the reason for past and present problems is the command economy-like debt system. This causes many challenges for investors, but understanding it also offers a lot of opportunities. The speculator often pays for his good sense of timing by being shaped too strongly by the spirit of the times, while the economist can easily let time pass him by, ensconced in his ivory tower. The Austrian School therefore emphasizes the importance of the one actor who is able to combine theory and practice: the visionary entrepreneur.

***"In short, the Austrian methodology is based on reality, not fancy, and its application in daily practice will provide an investor with favorable odds to achieve financial well-being."* – John Hathaway**