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## AUCTIONS

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Have you ever gone to an auction? Simply stated, what happens is that someone has a bunch of things they want to sell. Potential buyers are notified who then gather at the appointed time and place to try to buy some of these items. As each item is offered, bids are made, and then raised by someone else in a continuing process until finally no one is willing to offer a higher price. At that point, the highest bidder pays for the item and the next item is offered.

In theory, this is an effective means of selling for the highest price of the moment. Sure, sometimes it's a rainy day and the turnout is low. Maybe the people who would be willing to pay more are unaware of the auction and therefore not there to bid. Things like this could result in lower prices than could otherwise be had, but the opposite also happens. Sometimes a competitive spirit bursts out and, caught up in the moment, the bids go much higher than anticipated. Sometimes, a group comes together with a particular interest in the items. Occasionally, people decide to pay a slightly higher price than they originally had in mind when they began bidding. Overall, though, it is an effective means for selling at the highest price of the moment.

The biggest and most active formal auction market in the world is the financial market. Stock, bond and commodity markets match buyers and sellers all around the world in a continuous effort to find the "fair" price of (fill-in-the-blank) at any given moment. A disinterested observer could sit and watch these markets. Pretty soon, he would get a feel for what is attracting more buyers (because the price is rising) and what is attracting mostly sellers (because the price is falling). As Yogi Berra said, "You can observe a lot just by watching."

I spend a lot of time doing just that. I watch to see what buyers want to own and what owners want to sell. What I see right now is probably the most interesting picture I have ever seen in my 25 years in this business.

To explain this, let's start with two hands and a question. What do you think would happen in those auctions if you let people pay with a nearly unlimited supply of free money? Do you think they would hesitate to bid any price at all for whatever they want? The money is nearly unlimited, so why wouldn't they just bid higher and higher? If they need more they could just grab another handful and continue to bid.

This is happening right now.

First, you have the yen carry trade. That means that you can borrow all the money you want from Japan for almost nothing. You pay, say, 1%, and then invest that money in something earning, say, 5%, and you get to keep the difference. Free money! Take all you want!

Now, mix in a little sub-prime lending. Oversimplified, that means you lend money, in this case to buy a house, to people that you know can't pay back a normal loan. So you charge them, say, 12% interest, but you let them pay you just 2% today and add the other 10% to the loan. You both figure that within a short time they can sell the house for enough profit to pay you back the principal, the remaining interest, and have a little left over to put in their own pocket.

Put these groups together and you begin to generate massive amounts of new money, all sloshing around looking for something to buy, which then also causes some serious inflation in certain assets. Who cares how high the price goes? Money is available everywhere, you can get all you want, so bid, bid, bid and buy, buy, buy.

The only possible outcome in this situation is that the prices go up and up until, as with any auction, you finally find the highest bidder. Then the next item is offered. If the next item is identical to the one we just mentioned, it will sell this time for a lower price. The highest bidder just paid his top price, so now you have to sell to the second highest bidder at his (lower) price.

In this way, we collectively agree on the value of everything at a given moment. There is nothing that doesn't eventually have some price that becomes too high to pay. Even when the total supply is falling, the price will fall as well *once you have found the highest bidder*. You don't need to know *why* he became the highest bidder, but you do need to realize that he *is* the highest bidder.

In this case, though, we do know why. The money used to make these purchases is BORROWED money. The buyer still has to repay their loan. And now the lenders, both Japan and the sub-prime lenders, are asking for payment. If it takes more dollars to buy the yen needed to repay the loan in Japan, the borrower could find his profits wiped out. If the buyer can't sell the house for enough to cover the loan, he loses money and maybe goes into default. If that happens often enough, the lender is suddenly in trouble as well.

There is nothing new in any of this. Prices go too high in some area or another all the time. People take on too much debt. Bubbles burst. You always eventually find the highest bidder.

Now put all of that in one of the hands we mentioned before. Then take your other hand and grab this:

The amount of stock coming out of circulation in the US market is staggering. Companies are buying back their stock, private equity buyers and other companies are announcing the cash purchase of entire companies nearly every day, and the amount of new companies being added to the market has dwindled to almost nothing. We are talking about the disappearance of BILLIONS of dollars in shares every quarter.

While the supply of items in this auction is shrinking, the number of buyers is growing. There are now more hedge funds than there are stocks on the NYSE. That is on top of the fact that we already had more mutual funds than stocks trading on the major exchanges. Add in the ETF's (exchange traded funds) growing in number at a faster pace than any new security I have ever seen. ETF's are all some version of a basket of securities that trade on the exchanges. I am not even including all the new buyers in China, India, Russia, etc. Here you have an explosion of buyers combined with a disappearing inventory of the things they want to buy.

So, in one of your hands, you have vanishing liquidity (the lenders want their money back), excess supply in an auction where we have already seen the highest bidder of the day, and falling prices. In your other hand, you have an expanding group of buyers bidding against each other to buy assets which are becoming scarcer every day. Look at your two hands and choose. It doesn't seem to be very difficult deciding where the better opportunities might lie.

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