The Edelweiss Journal *contains excerpts from letters to the shareholders of Edelweiss Holdings Ltd. It is published quarterly and distributed electronically to friends and colleagues without charge or obligation. The opinions expressed are subject to change. Nothing in this publication is intended or should be taken as advice or guidance on any subject. Except where noted, the content of this publication is licensed under a Creative Commons Attribution 3.0 license. If you or a friend wishes to subscribe or unsubscribe to this distribution list, send an email to office@edelweissholdings.com with the subject heading "Edelweiss Journal."*

EDELWEISS JOURNAL

12 OCTOBER 2011 ISSUE 2

On gold swings and cluelessness galore

In announcing yet another round of money printing this week, Bank of England boss Mervyn King sounded almost apologetic as he described the world's financial state as "unfamiliar" because "this is the most serious financial crisis we've seen, at least since the 1930s, if not ever." He spoke of "unusual circumstances" yet offered no further explanation, suggesting only that "it is clear that the world economy is closing down at an even faster rate than people thought even a few months ago." This is precisely the sort of admission of cluelessness that Mr. Bernanke offered last June. When asked why all his money printing is not working, Bernanke opined that "we don't have a precise read on why this slower pace of growth is persisting." He went on to refer to the economic troubles as "puzzling" and "potentially more long-lasting than a temporary shock." One would think that the really puzzling matter is that no one is calling for the resignation of these two harlequins. Imagine a lowly school bus driver with a load of children driving aimlessly, getting hit by other cars and getting lost, but defending himself afterwards with words such as "unusual circumstances" or "unfamiliar." What is the likelihood he'd be given the keys to a school bus again?

Powerful as market forces may be to sort things out over the long-term, for the time being they are buffeted by forces of official intervention, ignorance, disbelief, cluelessness and a pinch of delusion. What else could explain the stubbornness of so many market participants to believe that this "crisis", like other downturns in the past, is bound to disappear given simply enough money and the expected resurgence of growth?

As for us, we see no hope that the actions of central banks will reverse the compounded consequences of a failed 40-year love-affair with a false economic model. All the glue and chewing-gum in the world cannot keep it together. To use a colloquial term, this is a "game-changer." And in that respect, Sir Mervyn is correct: we stand in "unfamiliar" ground. It must be quite unsettling indeed for him and his peers to realize that their so-called cures and solutions will ultimately be exposed for the chicanery that they truly are.

Still, while the cluelessness and delusion persists among market participants, we must contend with yet another cluelessness that mirrors the first: that of prices for all sorts of things.

The price of gold is no exception. From early January to the end of June, the price of gold in American money increased by a meager 6.3% to be followed by a lightning advance to more than $1'900—a dazzling 28% within the course of two months. And then came the plunge: a violent selloff that brought it back down to the 26 September intra-day low of $1'535—a 20% correction from the top. The price of silver experienced a similar swing, yet even more drastic. I fail to recall anyone asking as to the reasons behind its blinding summer price rise. On the other hand, on a post-plunge basis, you are forgiven for having asked, "What happened?" I did the same thing.

IN THIS ISSUE

1 On gold swings and cluelessness galore
3 Investing in the days ahead
9 Hans-Hermann Hoppe on entrepreneurship

In a world of instant pundits and experts, several explanations surfaced instantaneously. For sake of thoroughness, let me at least recall six of them. Some said that gold investors were disappointed at the lack of certainty over an eagerly expected third round of American money printing (QE3) and decided to unload their holdings. That's fair. Others suggested that a sudden requirement for a higher margin on some futures exchange forced some folks to sell their futures contracts. Someone opined that the equities markets' selloff in July and early August precipitated margin calls that forced the panicky liquidation of all things financial—gold included. Meanwhile, some dismissed the whole thing with the empty but saucy intimation that it was all a bubble anyway. Still others pointed their fingers to shadowy forces of government and ruling elites who somehow caused the plunge with an agenda to (a) generate greater confidence in the dollar or US bonds as a "safe haven," or (b) bring the price down before the massive money printing that is likely to come in Europe. The final explanation comes from a bimbo television reporter who suggested—I am not making it up—that gold holders decided to sell so as to find ultimate safety in US bonds, the only safe haven left in the world. So, there you have it, six genuine explanations in all.

Let's make a cup of tea and settle down. We saw something similar in 2008. After reaching the then-monumental $1'000 in mid-March, the price of gold (in American money) had fits and starts and ultimately plunged to $683 in October—a violent 34% drop. Similar explanations were also offered on that occasion. The world is plunging into a deflation and gold is going to $200, said an over-eager but ignorant blogger.

> Deflation-talk is the grown-up equivalent of the big bad wolf that terrorizes unruly children and makes them run to mommy.

Two years earlier, we had the same story. In May 2006, after a year-long advance from $420 to $680 (73%), inclusive of a 30% violent rise from mid-March to mid-May, the price of gold fell by 26% to $540. There were pundits even then. They mostly talked about, well yes, deflation. There's always been talk of deflation for as long as I can remember. Deflation-talk is the grown-up equivalent of the big bad wolf that terrorizes unruly children and makes them run to mommy.

There were several similar "plunges" even earlier, all replete with ready-made explanations of what happened. When the price of something goes down, it forces people to question why they owned it in the first place. Lower prices give rise to second-guessing. Rising prices hold the promise of even higher prices—just ask anyone who owns 10-year government bonds. So goes the life of "investors" since the days of the South Sea Company or perhaps even before.

As to the "plunge" of September 2011, the most learned explanation comes from my friend John Hathaway (*www.tocqueville.com*). He suggests that, of late, gold became another bandwagon populated by trend-followers, momentum players and hot money speculators. This is indeed true. We've seen gold recommendations from the most unlikely of sources. People piled on without really knowing why. In a world of zero interest rates, hedge-fund return appetites and cluelessness, there is desperation in the air for just about anything that "makes money." And so they piled on. Most of the piling on, in case you don't know, comes not from buying the physical metal but from the leveraged buying of futures—claims on gold.

And so, on a fine September day, we saw another sharp selloff that has sent the momentum-types and trend-followers packing. The hot money departs and gold goes to stronger hands.

Nothing has really changed. Investors everywhere demand more money printing. It's coming. In America, notwithstanding the well-documented (and largely intractable) fiscal and economic problems, I see a far greater risk about which few dare to speak. In my view, the United States, much like Greece, has become ungovernable. The consequences are far-reaching. Britain is among the walking dead. So is Japan. In China, however exalted its long-term potential, the consequences of so many years of central planning by the ruling party are finally becoming manifest in inflation, stagnation and uncertainty. European sovereign

and bank problems have become an unprecedented mess. Each passing day starts with optimism following the announcement of some plan to make a plan to save the banks, Greece and the European "dream." It is followed by pessimism when the plan fails, to be replaced shortly by optimism anew on account of yet another plan. The idea that Greeks and Italians would work alongside Germans under the same monetary umbrella is not funny any longer. It never was. The Greeks got the euro but were left free to issue bonds. They did that well. Zorba feasted on free money and those who lent it to him were happy to count it as capital and a "risk-free" asset—which they in turn used as collateral to borrow and lend even more. The PIIGS were precisely just that—pigs, and so were their bankers. It was a grand party that lasted much longer than even hardened eurosceptics guessed. But the party has now come to an inglorious end. All the talk of bank "stress tests" is mere confidence trickery. Austerity will not work either. It never works when imposed from the outside. All imposed austerity does is to plunge a nation into further impoverishment, at which point all they are left with, in the words of the legendary Nigel Farage, is "nationalism and violence."

We are in a period that has been described as paralysis. No one agrees as to who should pay for the problem. Indeed, we are in "unusual circumstances," but not the kind that Mr. King is pondering. Something is undoubtedly amiss when the head of the European Central Bank is Italian and the Pope is German. Oh, the irony of history!

There is much talk about the survival of the euro, but as the problem is political rather than economic, no one knows the outcome. What we can guess with a modicum of confidence is that Mr. Mario Draghi, once he is settled in his new office in Frankfurt and has a chance to confer with his old employer, will undoubtedly embark on the largest money-printing event in history. He has no choice, really. Mr. Hildebrand did have a choice. He chose to tie the venerable Swiss franc to the euro. It's like hanging on to a piece of floating turd so as not to sink. In the end, perhaps by some grand design, we are left with no currency choices. We are forced to park our savings in one or more of equally distasteful options. It is not surprising to see so many endorsing the US dollar and its bonds in terms of "confidence." It is the kind of confidence that the regime can ill afford to lose. And, for that reason, such a regime would undoubtedly be pleased to see gold discredited. But this hope too will pass.

Allow me to remind you once again that we hold gold not to become rich, but rather, in the words of Mr. Bernanke back in July when he was asked why people would want to own gold, "as protection against of what we call tail risks: really, really bad outcomes." It is the ownership of gold that matters to us and not its price. It seems to us that Mr. Bernanke's "really, really bad outcomes" are not simply "tail risk" but a certainty of things to come. (TD)

Investing in the days ahead

Edited remarks by Tony Deden from the Edelweiss Holdings Symposium held in Zürich on 17 September 2011

Ever so slowly, the credibility of the experts of our age is being destroyed. The problem with our experts, our great central bankers, our political leaders, our economics professors and all the esteemed financial journalists is not that they are not intelligent. It isn't that they are not educated. Indeed they are and, frankly, they do know a lot. The problem is that much of what they do know just isn't so.

Our world is falling apart. It is the compounded outcome of a 40-year old experiment with false ideas. The problems we face all relate to money. And so, unless we understand the nature of money and capital, we cannot possibly operate successfully or understand the risks we face.

Misunderstanding money introduces problems to investment calculation and by extension valuation: it leads to the misunderstanding of risk; and it increases the desire for money rather than the accumulation of wealth.

John Maynard Keynes, the intellectual father of our generation of experts, a most intelligent man by all accounts, once wrote: “As the inflation proceeds and the real value of the currency fluctuates wildly from month to month, all permanent relations between debtors and creditors, which form the ultimate foundation of capitalism, become so utterly disordered as to be almost meaningless; and the process of wealth-getting degenerates into a gamble and a lottery.” This is precisely where we find ourselves: a “degenerate” environment with respect to all issues. To be successful, or perhaps to merely survive, we need two crucial components: correct theory and correct entrepreneurship.

Economics is to an entrepreneur what mathematics is to an engineer. A mathematician, however intelligent, cannot build a bridge. But on the other hand, an engineer could never build a bridge without knowing mathematics. Let me give you another analogy: Imagine you are in an absolutely dark room. Nothing makes sense. No matter your intentions, you ultimately must take a gamble as to whether to go forward backward, left or right. Then someone turns on a light. That is correct theory. Correct economic theory does not help us decide as to where to go or what to do. It merely illuminates the premises and allows us to come to our own conclusions as to the obstacles, and the means of engaging in our objectives.

My favorite maxim about the future comes from Marcus Aurelius, the Roman emperor and Stoic philosopher. “Never let the future disturb you,” he wrote. “You will meet it, if you have to, with the same weapons of reason which today arm you against the present.” Seemingly back then people *did* have “weapons of reason.” The older I get, the smarter some long-dead people seem to become and the more pertinent their old ideas.

Frankly, none of us can see ten years ahead. We know that our current world is ripe with potential for extraordinary change: financial, economic, social and geopolitical. I imagine we will have changes that we cannot even guess. I also imagine the changes to come will be more significant than those of the last decade. But we don't know. In the minimum, with some effort and perhaps some of our own "weapons of reason," we can make small extrapolation of trends.

The gold question

Before addressing any other topic, I will try to answer the most burning question you have and are perhaps afraid to ask: When will we sell our gold?

To paraphrase Solomon, there is a time to buy and a time to sell. To be successful, both the purchase and the sale require courage, patience, preparedness, understanding and conviction. It is also necessary to have a lack of emotional attachment in the decision process and a keen sense of value. And with that, we will indeed sell our gold when the time comes.

Our current world is ripe with potential for extraordinary change: financial, economic, social and geopolitical.

We are watching for one of two conditions. Condition No. 1 is when there is a reversal, or even the hint of reversal, of the reasons that compel us to own it in the first place. Condition No. 2 is when we find something else we'd love to own that we value more than gold. Each of these conditions we can examine a bit further.

As you know, years ago, we exchanged our cash for gold, and we have chosen to keep it to this day, despite the ups and downs in its price. Gold may be a “store of value” as they say, but then again, by definition, stores are temporary. At some point we need to take it off storage and deploy it. So, it is a fair question: How likely is it that the circumstances that compelled us to buy gold and hold it are likely to change in the future? And when in the future will that be? To be honest, I don't know.

At 61% of total assets, gold and silver are the cornerstone of our present position. If it isn't money, it is a rich man's store of value. Others may find solace in German government bonds or French inflation-protected obligations. Many even see value in the ownership of US bonds. There was a time when we owned a lot of bonds as well. But that's history.

Haven’t there been any hints of change, you ask? Well, one would think that the massive failure of governments and the demonstration of enormous

incompetence on the part of the political elites would have provoked a re-examination of the most basic assumptions in investment finance. At the least, it should have brought about some fear. But it hasn't—not yet. Let me explain.

If you read the newspapers or peruse any of the thousands of websites that deal with matters financial, you see a widespread and deep longing for things to get back to normal. What is "normal," I ask you? Is it anything more than the very reason of our predicament? Can you possibly treat a disease you have misdiagnosed? I find no experts offering credible objections to the idea of monetary debasement and competitive currency devaluations as a way of solving the problem of too much debt. It is sheer delusion. They all seem to believe that more money will save our banks and our financial system and help us keep the promises we made. It will return us to a "sustainable path," they say. Clive Crook, writing recently in the *Financial Times*, even urged the Fed to do more: "When a treatment becomes less effective, you might switch to an alter-native: if there is no alternative, you increase the dose." No, Mr. Crook, that just isn't so.

Anything real multiplied by something false results in false.

No one would argue that if I were to take some of the banknotes out of your wallet, I would be a criminal and should be dealt with accordingly. Not even if my intention was to give the money to someone who had less or someone who needed help. I'd still be a criminal. Yet if I somehow make the money in your wallet worth less, I can get elected to be the president of some central bank. I would be lauded and praised. But, essentially, I have committed the same action. And by necessity, it is equally criminal. Again, very few recognize this.

For the modern investor, the concept of "normal" is just as delusional: a stock index that keeps going higher. That is the beginning and end of his understanding of anything. The only thing he knows is what has worked in the past: more monetary accommodation means higher stock prices. The boards and CEOs of companies are just as convinced. But that just isn't so.

Despite the utter failure of the socialism that has defined our modern age, and despite the fraud and gangsterism of governments everywhere, our Western societies are ripe with anger that somehow capitalism has failed. Richard Posner's book *A Failure of Capitalism* (2009) in fact goes further. He writes that "the financial crisis is indeed a crisis of capitalism rather than a failure of government" (p. 240). Oh yes, if only government had done something more! Mr. Krugman would agree. Read the papers. Virtually all is about what government has done, or government will do, or should have done or shouldn't have done. Any criticism is superficial. Government is seen to be our ultimate savior from the evils of capitalism. That just isn't so.

In investment practice, when it comes to the elusive search for value, let's face it: Graham & Dodd are dead. Their brilliant contributions to investment analysis have been rendered useless in our epoch of false equations, false definitions, false assumptions, false accounting, distortions upon distortions, interventions, fraud, habits that confuse the real economy from illusory finance and the pretentiousness that hides within the moral ambiguity of handling other people's money. Just as it is in mathematics—multiplying any number by zero yields zero, my corollary is true to the same extent: Anything real multiplied by something false results in false. Yet, virtually everyone in investment practice, particularly those who profess an interest in investing in value, or following the intellectual contributions of Graham, Dodd and other pioneers in the field of valuation, insists on the utility of such calculations as an appropriate method in capital allocation. That just isn't so.

So, to answer the question: no, I don't see reversals or hints of an awakening. Not yet. And so, we own gold as an insurance policy. Its price, just as any insurance premium, will change. We bought it when the premium was cheap. But it is getting more expensive. During periods of disequilibrium, insurance premiums explode and are known to be volatile.

I once wrote to you that gold gives us time to think. We have been thinking ever since. Should a hint or a catalyst come about that the conditions may change, we will consider selling our loot. For now, the state is openly committed to a policy of inflationism. There is no other option.

We don't know how long it will take and have no idea how it will come about. It may take years. In the meantime, the price of gold could go to 2'000, then down to 1'500, then back up to 3'000—or more, or less. No one really knows. People make speculations for reasons of their own. They don't know. In holding gold over so many years, I have never been impressed with the endless analysis that follows every tick up and down in price. As the years have past, more and more experts have surfaced and they all have some unsolicited opinion about the latest little blip. I have been uninterested in blips. It is best to understand circumstances and trends. What matters is not the price of gold. If you keep looking at its price, you are looking at the wrong thing. What matters is that we own it.

The accumulation of capital is a way of thinking—not an investment strategy.

We own gold for precisely the reason that it cannot be "valued" with tools of traditional finance. As a rich man's money, gold is most dear when things are most difficult and is more richly valued as confidence and trust in our existing monetary order wanes. I see it not as an investment but as a cash pool that will give us purchasing power over the time to come. My valuation is subjective and it is defined largely by the circumstances in which we find ourselves. Gold gives us independence, scarcity and an element of permanence. And that is worth much to us.

As for Condition No. 2, it is also conceivable that we will sell our gold, or some of it, when a different kind of asset offers us greater fair value. In fact, looking for such assets is where we deploy most of our energy and focus. However, it is a slow process.

In the end, gold is not an instrument of wealth creation. Wealth is created not in the stock market either. Real wealth is created by entrepreneurs and our ultimate aim is to participate in such wealth creation. This is precisely why we hold so much cash and gold: for the purpose of deploying it into physical and entrepreneurial assets.

How to "arrange our affairs"?

On that note, we can now address the road ahead. You see, we have identified the large macroeconomic problems. We understand the causes and can even speculate about its impact. Moreover, we understand the predicament in which anyone with savings finds himself. Still, it makes no sense to keep dwelling on these facts. We must go on to focus on what is our task at hand: What do we do?

There are some who have urged me to sell everything, just buy gold and hold. Others have urged me to increase our stake in some of our extraordinary entrepreneurial assets—and then just hold.

I have noticed that the motivation behind the idea of constantly doing something is rooted in the quest for performance. Allow me this view: wealthy people should not care about performance, but rather about adding to their capital. They should not care about missing out on opportunities so much as the avoidance of large errors. The accumulation of capital takes years—and it is a way of thinking—not an investment strategy.

Allow me to repeat a few comments I shared with you at last year's symposium in London. I said to you that it is not wise to have a strategy in a time of utter distortions. But I added that what is important is to be fixed on our objective. I also suggested that opportunities come irregularly—there is no point in looking for them. What is vastly more important is to spend time learning how to recognize them. In comparing our task to that of an entrepreneur, I shared with you this marvelous description of purposeful entrepreneurial action—from Ludwig von Mises himself. He wrote:

> What distinguishes the successful entrepreneur from other people is precisely the fact that he does not let himself be guided by what was and is, but

> arranges his affairs on the ground of his opinion about the future. He sees the past and the present as other people do; but he judges the future in a different way. (*Human Action*, p. 582)

My imperfect idea as to the manner in which we ought to arrange our affairs is to propose that we think as entrepreneurs. Since more that 70% of our capital belongs to retired or active entrepreneurs, the idea should come close to home.

Entrepreneurs operate in the real economy—the one that most investors disregard. They do not see the idea of wealth accumulation as a score on a stock exchange. I don't know a single one among them who knows precisely what he is worth at any one time. They are motivated by two desires: first, to stay in business—and here is your capital preservation, and second, to increase their accumulated capital.

> We need to have an investment company whose substance is embedded on three distinct pillars: first, a foundation of independence; second, a basis in scarcity; and third, a culture of permanence.

Allow me to share with you just an example of unheralded and exceptional entrepreneurship. Many people talk about the famous "oracle" from Omaha as "exceptional." Without wishing to take anything away from the record of such a famous investor, let me only suggest that I know of many others whose record in wealth creation is, in fact, far greater both in substance and in enduring value. Some of them even define, in my view, what it means to be exceptional.

One such man is Martijn van der Vorm. If you've never heard his name, that is precisely because that's the way he likes it. He is the long-standing CEO of a company whose name is equally unknown even though its shares are listed: HAL Trust. Mr. van der Vorm, unlike most CEOs-cum-stock peddlers, does not talk to analysts. He has never given an interview. He makes no earnings estimates. He doesn't even meet his shareholders—or write them fancy letters. His company has no PR firm or shareholder relations officer. But he has built it into an extraordinary collection of assets. He owns a big chunk of the company himself, and as far as I can tell from observing share changes, most of the shareholders are just like him. Owners. Quiet, unassuming and purposeful.

Without noise or fanfare, over the last 20 years, a shareholding in HAL has brought a powerful 5'300% (24% annualized) return with dividends reinvested. This entrepreneur does not need banks or financial engineering types. He probably doesn't even know the price of his shares at any one moment or the fact that they aren't liquid enough to dabble by hedge funds and other institutional types. HAL is owned by owners and managed by owners. Without a doubt, Mr. van der Vorm understands something that 99% of all investors and bankers never will: the principle of capital accumulation. I have never met this man, but just by watching his work over years, I have come to respect him. I could spend hours describing this company to you. But I could also spend days telling you about other men who are just like Mr. van der Vorm: owners.

Investors are mesmerized by the world of finance and money, the world of foreign exchange movements, fancy bond metrics, CDS-premiums, and all the hoopla that has nothing to do with anything real. They forget that there is another economy—the productive kind, the real kind, the contributing kind. Some of it is owned and run by men like Martijn van der Vorm. It a subset that our financial world has forgotten. Not enough liquidity, they say. Not enough transparency or not enough volatility. Too small. Not sexy enough. Not on an index. Unpromoted. And so on.

I have discovered some common traits about the character of this small subset of owner-managed companies even as their pursuits are different. These are the traits that I believe give them an enduring advantage—and none of them is financial in nature. As we ponder the manner in which we ought to arrange our affairs, such are the traits that apply equally to ourselves. That is, we need to have an investment company whose substance is embedded on three distinct pillars: first, a foundation of independence; second, a

basis in scarcity; and third, a culture of permanence.

Let's forget being a fund and think of ourselves as owners of capital. When I think of successful entrepreneurs (by which I mean those who have built something enduring), I can assure you that all of them, whether they knew it or not, strived to remain fixed on these three constraints.

We could never achieve independence in absolute terms, but we can strive toward it. I speak of independence from government, from legal ambiguity, from agency conflicts, from the culture of finance, from bureaucracy, and from political and geographic constraints. Independence both in thought and in action. Such a foundation of independence is not something we can build overnight. It takes time and effort to approach it and vigilance in protecting it.

The second pillar is scarcity. As an example, good people are scarce and companies who have good people also possess such scarcity. Find me a principled, honorable CEO who runs a company that he owns, and I will show you something scarce.

Just as invaluable is the scarcity component in the assets we choose to own. Scarcity is economic strength that goes beyond the balance sheet. Scarcity is economic goodwill—not the accounting variety. Scarcity is an economic advantage that is difficult to imitate. But it should also be a component of value that we must calculate. Whether it is with respect to people with a passion, or barriers to entry, or other economic advantages, scarcity should form an insurmountable barrier in our investment collection.

And finally, our third pillar is that of a culture of permanence. We live at a time when investors are fixated on short-term results. So are the people who run the vast bulk of the enterprises whose shares trade on some roulette table. And so are the people who manage our money, despite what they say to the contrary. We live in a culture of credit, not one of ownership.

Owners seek an enduring advantage. Owners have low time preference—they have long horizons. Owners create a culture of trust, of responsibility, of accountability and of ownership. Owners do not get fixated on growth for the sake of growth. Owners are more stable and less sensitive to business cycles. They are more nurturing of employees, suppliers and customers. They are not sensitive to costs but to customer value. They have less debt and more cash. They do not engage in constant reorganizations and financial engineering. They are not in the least interested in stock options—they are owners. Owners do not play with other people's money. They view capital as their own. A culture of permanence is a culture of stewardship.

Ladies and gentlemen, the purchasing power of money is best protected by the nature of capital that it commands. And wealth is not created by some "earnings per share" magic. It is only created by the accumulation of capital.

Notice that I have not spoken to you about an investment strategy of comparative fixed-income duration statistics, or industry focus, book values or some irrelevant discounted cash flow calculation. I did not mention volatility, diversification or other such terms. I did not make mention of foreign exchange prices, stock market indices or any metrics. These are the terms of our culture that everyone mimics and calculates. We are entirely unconcerned with what others do. This too is an integral part of entrepreneurship.

Late last year I was contemplating how I might invest my own savings after retiring. I sat down with a piece of paper to outline my thoughts about the principles I was going to follow if all I had was my own money to invest, and if I needed to have the time to read and write and go for long walks in the mountains and not be tied down to a chair reading annual reports. It was a long and intense period of searching for what was sensible. I wanted to become an owner.

We live in a culture of credit, not one of ownership.

I made a mental survey of all the investment decisions I ever made—the good ones and the bad. I also recalled all that I had ever learned about the nature of capital, investment, time-preference, entrepreneurship and risk. And somewhere along the way, I came to see the Edelweiss investment

Continued on page 13

Entrepreneurship with fiat money and fiat property

By Hans-Hermann Hoppe

Remarks from the Edelweiss Holdings Symposium held in Zürich on 17 September 2011

Let me begin with a brief description of what a capitalist-entrepreneur does, and then explain how the job of the capitalist-entrepreneur is changed under statist conditions.

What the capitalist does is this: He saves (or borrows saved funds), hires labor, buys or rents capital goods and land, and he buys raw materials. Then he proceeds to produce his product or service, whatever it may be, and he hopes that he will make a profit.

Profits are defined simply as an excess of sales revenue over the costs of production. The costs of production, however, do not determine the revenue. Otherwise, if the cost of production would determine price and revenue, everyone could be a capitalist. No one would ever fail. Rather: It is anticipated prices and revenues that determine what production costs the capitalist can possibly afford.

The capitalist does not know what the future prices will be or what quantity of his product will be bought at such prices. This depends on the consumers, and the capitalist has no control over them. The capitalist must speculate what the future demand for his products will be, and he can go wrong in his speculation, in which case he does not make profits but will incur losses instead.

To risk your own money in anticipation of an uncertain future demand is obviously a difficult task. Great profits may await you, but also total financial ruin. Few people are willing to take this risk, and even fewer are good at it and stay in business for a lengthy time.

In fact, there is even more to be said about the difficulty of being a capitalist.

Every capitalist stands in permanent competition with every other one for the invariably limited amounts of money to be spent on their goods and services by consumers. Every product competes with every other product. Whenever consumers spend more (or less) on one thing, they must spend less (or more) on another. Even if a capitalist has produced a successful product and earned a profit, there is nothing that guarantees that this will go on. Other businessmen can imitate his product, produce it more cheaply, underbid his price and outcompete him. To prevent this, every capitalist must thus continuously strive to lower his production costs. Yet even trying to produce whatever you produce ever more cheaply is not enough.

The set of products offered by various capitalists is in constant flux, and so is the evaluation of these products by consumers. Continuously new or improved products are offered on the market and consumer tastes constantly change. Nothing remains constant. The uncertainty of the future facing every capitalist never disappears. There is always the lure of profits but also the threat of losses. Again, then: it is very difficult to be continuously successful as a businessman and not to sink back to the rank of an employee.

In all of this there is only one thing that the businessman can count on and take for granted, and that is his real, physical property—and even that is not safe, as we will see.

His real property comes in two forms. First, there are the physical resources, the means of production, including labor services, that the capitalist has bought or rented for some time and that he combines in order to produce whatever he produces. The value of all of these items is variable, as already explained. It depends ultimately on consumer evaluations. What is stable about them is only their physical character and capability. But without this physical stability of his productive property the capitalist could not produce what he produces.

Second: Besides his productive property, the capitalist can count on his ownership of real

money. Money is neither a consumer good, nor is it a producer good. It is the common medium of exchange. As such it is the most easily and widely sold good. And it is used as the unit of account. In order to calculate profit and loss, the capitalist needs recourse to money. The input factors and the output, his products to be produced, are incommensurable, like apples and oranges. They are made commensurable only insofar as they can all be expressed in terms of money. Without money, economic calculation is impossible, as Ludwig von Mises above all has explained. The value of money, too, is variable, like the value of everything else. But money, too, has physical characteristics. It is commodity money, such as gold or silver, and money profits are reflected in an increase in the supply of this commodity, gold or silver, at the disposal of the capitalist.

What can be said, then, about both the capitalist's means of production and his money, is this: their physical characteristics do not determine their value, but without their physics, they would have no value at all, and changes in the physical quality and quantity of his property do affect the value of his property, whatever other factors (such as changing consumer evaluations) may affect the value of his property also.

Now let me introduce the State and see how it affects the business of the capitalist.

The State is conventionally defined as an institution that possesses a territorial monopoly of ultimate decision-making in every case of conflict, including conflicts involving the state and its agents itself, and, by implication, the right to tax, i.e., to unilaterally determine the price that its subjects must pay to perform the task of ultimate decision-making.

To act under these constraints—or rather, lack of constraints—is what constitutes politics and political action, and it should be clear from the outset that politics, then, by its very nature, always means mischief.

More specifically, we can make two interrelated predictions as to the effect of a state on the business of business. First, and most fundamentally, under statist conditions real property will become what may be called fiat property. And secondly and more specifically, real money will be turned into fiat money.

First: With the state being the ultimate arbiter in every case of conflict including those in which it is involved itself, the state has essentially become the ultimate owner of all property. In principle, it can provoke a conflict with a businessman and then decide against him by expropriating him and making itself (or someone of its liking) the owner of the businessman's physical property. Or else, if it doesn't want to go as far, it can pass legislation or regulations that involve only a partial expropriation. It can restrict the uses that the businessman can make of his physical property. Certain things the businessman is no longer permitted to do with his property. The state cannot increase the quality and quantity of real property. But it can redistribute it as it sees fit. It can reduce the real property at the disposal of businessmen or it can limit the range of control that they are allowed over their property; and it can thereby increase its own property (or that of its allies) and increase its own range of control over existing physical things. The businessmen's property, then, is their property in name only. It is granted to them by the state, and it exists only as long as the state does not decide otherwise. Constantly, a Damocles sword is hanging over the heads of businessmen. The execution of their business plans is based on their assumption of the existence, at their disposal, of certain physical resources and their physical capabilities, and all of their value-speculations are based on this physical basis being given. But these assumptions about the physical basis can be rendered incorrect at any time—and their value-calculations vitiated as well —if only the state decides to change its current legislation and regulations.

> Politics, then, by its very nature, always means mischief.

The existence of a state, then, heightens the uncertainty facing the businessman. It makes the future less certain than would be the case otherwise. Realizing this, many people who might otherwise become businessmen will not become businessmen at all. And many businessmen will see their business plan spoiled. Not because they

did not correctly anticipate future consumer demand, but because the physical basis, on which their plan was based, was altered by some unexpected and unanticipated change in state laws and regulations.

Second: Rather than meddling with a businessman's productive capital through confiscation and regulation, however, the state prefers to meddle with money. Because money is the most easily and widely saleable good, it allows the state operators the greatest freedom to spend their income as they like. Hence the state's preference for money-taxes, i.e., for confiscating money income and money profits. Real money becomes subject to confiscation and changing rates of confiscation. This is the first sense, in which money becomes fiat money under statist conditions. People own their money only insofar as the state allows them to keep it.

People own their money only insofar as the state allows them to keep it.

But there is also a second, even more perfidious way, in which money becomes fiat money under statist conditions.

States everywhere have discovered an even smoother way of enriching themselves at the expense of productive people: by monopolizing the production of money and replacing real, commodity money and commodity credit with genuine fiat money and fiat or fiduciary credit.

On its territory, per legislation, only the state is permitted to produce money. But that is not sufficient. Because as long as money is a real good, i.e., a commodity that must be costly produced, there is nothing in it for the state except expenses. More importantly, then, the state must use its monopoly position in order to lower the production cost and the quality of money as close as possible to zero. Instead of costly quality money such as gold or silver, the state must see to it that worthless pieces of paper, which can be produced at practically zero cost, will become money.

Under competitive conditions, i.e., if everyone is free to produce money, a money that can be produced at zero cost would be produced up to a quantity where marginal revenue equals marginal cost, and since marginal cost is zero the marginal revenue, i.e., the purchasing power of this money, would be zero as well. Hence, the necessity to *monopolize* the production of paper money, so as to be able to restrict its supply, in order to avoid hyper-inflationary conditions and the disappearance of money from the market altogether (and a flight into "real values")—and the more so the cheaper the money-commodity.

Having monopolized the production of money and reduced its production cost and quality to virtually zero, the state has made a marvelous accomplishment. It costs almost nothing to print money and one can turn around and buy oneself something really valuable, such as a house or a Mercedes.

What are the effects of such fiat money, and in particular what are the effects for the business of business? First and in general: more paper money does not in the slightest affect the quantity or quality of all other, non-monetary goods. Rather, what the additional money does is twofold. On the one hand, money prices will be higher than they would otherwise be and the purchasing power per unit of money will be lower. And secondly, with the injection of additional paper money existing wealth will be redistributed in favor of those receiving and spending the new money first and at the expense of those receiving and spending it later or last.

And specifically regarding capitalists, then, paper money adds another dose of uncertainty to his business. If and as long as money is a commodity, such as gold or silver, it may not be exactly "easy" to predict the future supply and purchasing power of money. However, based on information about current production costs and industry profits it is very well possible to come up with a realistic estimate. In any case, the task is not pure guesswork. And while it is conceivable that with gold or silver as money nominal money profits may not always equal "real" profits, it is at least impossible that a nominal profit should ever amount to nothing at all. There is always something left: quantities of gold or silver.

In distinct contrast: With paper money, the

production of which is unconstrained by any kind of natural (physical) limitations (scarcity) but dependent solely on subjective whim and will, the prediction of the future money supply and purchasing power does become guesswork. What will the money printers do? And it is not just conceivable, but a very real possibility, that nominal money profits turn out to represent literally nothing but bundles of worthless paper.

Moreover, hand in hand with fiat money comes fiat or fiduciary credit, and this creates still more uncertainty.

If the state can create money out of thin air it also can create money credit out of thin air. And because it can create credit out of thin air, i.e., without any previous savings on its part, it can offer cheaper loans than anyone else, at below-market rates of interest, even at rates as low as zero. The interest rate is thus distorted and falsified, and the volume of investment will become divorced from the volume of savings. Systematic mal-investment is thus generated, i.e., investment unbacked by savings. An unsustainable investment boom is set in motion, necessarily followed by a bust, revealing large-scale clusters of entrepreneurial errors.

Last but not least, under statist conditions, i.e., under a regime of fiat property and fiat money, the character of businessmen and of doing business is changed, and this change introduces another hazard into the world.

Absent a state it is consumers that determine what will be produced, in what quality and quantity, and who among businessmen will succeed or fail. With the state, the situation facing businessmen becomes entirely different. It is now the state and its operators, not consumers, who ultimately decide who will succeed or fail. The state can keep any businessman alive in subsidizing him or bailing him out; or else it can ruin anyone by deciding to investigate him and find him in violation of state laws and regulations.

Moreover, the state is flush with taxes and fiat money and can spend more money than anyone else. It can make any businessman rich (or not). And the state and its operators have a different spending behavior than normal consumers. They do not spend their own money, but other people's money, and in most cases not for their own, personal purposes, but for those of some anonymous third parties. Accordingly, they are frivolous and wasteful in their spending. Neither the price nor the quality of what they buy is of great concern to them.

In addition, the state can go into business itself. And because it doesn't have to make profits and avoid losses, as it can always supplement its earnings through taxes or made-up money, it can always outcompete any private producer of the same or similar goods or services.

And finally, by virtue of its ability to legislate, to make laws, the state can grant exclusive privileges to some businesses, insulating or shielding them from competition, and by the same token partially expropriate and disadvantage other businesses.

In this environment, it is imperative for every businessman to pay constant and close attention to politics. In order to stay alive and possibly prosper, he must spend time and effort to concern himself with matters that have nothing to do with satisfying consumers, but with power politics. And based on his understanding of the nature of the state and of politics, then, he must make a choice: a moral choice.

It is now the state and its operators, not consumers, who ultimately decide who will succeed or fail.

He can either join in and become a part of the vast criminal enterprise that is the State. He can bribe politicians, political parties or public officials, whether with cash or in-kind (including promises of future employment in the "private" sector as "board-members," "advisors" or "consultants"), in order to gain for himself economic advantages at the expense of other businesses. That is, he can pay bribes to secure state contracts or subsidies for himself and at the exclusion of others. Or he can pay bribes for the passing or maintenance of legislation that secures him and his business legal privileges and monopoly profits (and capital gains) while partially expropriating and thus screwing his competitors.

Needless to say, countless businessmen have chosen this path. In particular big banking and big industry have thus become intricately involved in the state, and many a wealthy businessman has made his fortune more on account of his political skills than his abilities as a consumer-serving economic entrepreneur.

Or else: a businessman can choose the honorable but at the same time also the most difficult path. This businessman is aware of the nature of the state. He knows that the state and its operators are out to get him and bully him, to confiscate his property and money and, even worse, that they are arrogant, self-righteous, haughty, and full of themselves. Based on such understanding, this very different breed of businessman then tries his best to anticipate and adjust to the state's every evil moves. But he does not join the gang. He does not pay bribes to secure contracts or privileges from the state. Instead, he tries as good as he can to defend whatever is still left of his property and property rights and make as large profits as possible in doing so.

Prof. Dr. Hans-Hermann Hoppe is an Austrian economist and libertarian philosopher. He is Professor Emeritus at the University of Nevada, Distinguished Fellow at the Ludwig von Mises Institute, the founder and president of The Property and Freedom Society and the former editor of the *Journal of Libertarian Studies*. His numerous publications include *Democracy: The God That Failed* and *The Economics and Ethics of Private Property*.

Continued from page 8

portfolio as a collection of assets that in the whole possessed these three essential qualities: independence, scarcity and a culture of permanence. Furthermore, I came to see every single one of the items in our collection in terms that add to the whole.

From a young age, I have been fascinated with the idea of valuation. Every time I walk into a store, my first involuntary thought is to estimate the economics of the business. I have learned all that modern finance has to teach about valuation. But over the years, I came to despise the mathematics of valuation—not because it is inaccurate but because it is irrelevant to owners of capital. The owner of capital must come to an independent, subjective and personal assessment of the valuation approach. We value things differently because we weigh them differently.

Eventually, the epoch of credit and leverage will die: Sovereigns will default and the errors of the past will come to light. Pensions will be lost and savings will become worthless. This is a fact. Oh, we have some gold, you say. Yes, but gold is not really a salvation. Gold gives us an element of independence and scarcity—temporarily. What will give us greater independence and wealth is to focus on the physical capital and the physical entrepreneur. Not your average one and not the rent-seeker, but the one whose foundation is independent, whose operating basis rests on some element of scarcity and who understands this idea of permanence. This is precisely what ownership entails. And this is precisely how we plan to arrange our affairs—purposefully, honestly and ever so slowly. (TD)