

Investing Through Inflation

What is an Intangible Intangible Asset?

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What is an Intangible Intangible Asset?

Summary: Intangible assets have value if they are tied to producing cashflows. That would be a tangible intangible such as a patent. There are intangible intangibles such as branding that prove to have valuation difficulties. When intangible intangibles grow too large they can be ruinous. Fiat currency is an intangible intangible.

In 2006 I had the opportunity to explore a new career direction. I reflected on my impression that the early days of hedge funds were interesting, exciting and fun because we were playing in a field where there were few players. To a certain degree we were sourcing advantageous returns because the securities we trafficked in weren't well understood and were therefore inefficiently priced leading to attractive and rewarding risk adjusted returns. As happens in markets, those opportunities waned as more capital, better models and higher IQ's came into the game. So I set upon the task to see if I could uncover another, or the next, opportunity that was likewise not well trafficked and offered the fun and excitement and, if properly executed, a new source of attractive returns.

What I settled on and chose to pursue was a line item on corporate balance sheets that was under serviced, under financed and misunderstood. The intangible asset. In particular the intangible asset of my choosing was intellectual property. I embarked on setting up an alternative investment fund to finance intellectual property. A long story to be told a different time, it has been an unrequited pursuit that I continue today. But along the way I learned a thing or two about intangibles. Germane to this paper is the valuation of intangibles and the difference between tangible intangibles and intangible intangibles. Akin to Rumsfeld's known unknowns and unknown unknowns.

The distinction between tangible and intangible intangibles is the former can be valued while that latter cannot. Examples of tangible intangibles include patents, software, customer lists, copyrights, trademarks, accounts receivables and mineral rights to name a few. Weighty tomes have been written on how to value these assets. Essentially, they all seem to revert to a complicated equivalent of a discounted cash flow model. Whereas intangible intangibles simply cannot be valued. You work backwards and plug in a number to solve for their value. For example, balance sheet assets have to equal liabilities. When there's a mismatch the balancing value gets plugged in as an intangible value on the asset side. All manner of unsolvable assets get bucketed into 'intangibles'; goodwill, brand value being two that easily come to mind.

Intangible intangibles, as an asset, can prove to be perilous to one's wealth. In small doses they can be ignored. They appear benign. However, as they grow on the balance sheet they take on the equivalent of that grain of sand being added to a sand pile. You can trust the sandpile is stable. Right up until you can't. With disastrous outcome. A sand slide as per the metaphor or a loss of capital as per an investment.

An illustrative example would be the once great Canadian company Nortel. Nortel grew rapidly in the late 1990's taking advantage of the parabolic growth of the fibre optic industry as the internet was developing. Nortel's CEO seized acquisition opportunities using its appreciating stock price as the currency for acquisitions. Here's where the intangible intangible comes into play. When the acquisition price was greater than the book value of the target company the difference was added into Nortel's 'goodwill' asset line. By fiscal year end 2000 Nortel's Intangible Asset line was \$18 b of its \$42 b billion asset total. It was the largest line item on the asset side of the balance sheet weighing in at 43% of the company's assets. Come the 2000 tech crash a write down of intangibles was required resulting in a write off of up to \$14 b in asset value. Nortel's stock price collapsed from \$124 to \$0.47.

The takeaway point of Nortel is the illustration that an intangible intangible has no value. It's ignorable in small amounts but at an extreme it is destabilizing. The destabilization is triggered as soon as faith is lost. As soon as the unknown unknown is known to have no value. A reliance on an intangible intangible asset requires faith and trust and once breached there will be chaos and losses.

Where within our portfolios does an intangible intangible exist? Where are we relying on faith and trust? Shockingly it's the largest asset in the world. Currencies, specifically fiat currencies. I cannot over emphasize that the fiat world we exist in has no precedent. There is no time in history, of any relevance, in which the entire world's currency system was fiat, i.e., faith based. Why is a US dollar worth a dollar? As an intangible intangible it's only because we have faith it is. A country's fiat currency only has its value until that faith is lost.

Fiat currency exists on the belief in a sovereign's ability to grow its economy, tax or print more money. The eventual lack of confidence in growth and the ability to tax leaves only printing. History has not been kind to countries whose last resort is to print money with no limit.

Phil Schmitt
President & CEO
Summerwood Capital Corp.

Contact me at;
info@summerwoodgroup.com
[LinkedIn](#)

