



**FINANCIAL ADVANTAGE, Inc.®**

*for a better life®*

## The *Blue Sheets*®

*Our quarterly commentary on the global economy and securities markets*

**July 2009**



## The World Is **CHANGING**... Again!

*Thomas Rowe Price, founder of the eponymous mutual fund giant, opined famously that “Change is the investor’s only certainty.” As our thoughts ramble back across the eons, a startling range of famous change agents parade before our mind’s eye: The taming of fire; the first tradesman to hitch a wheeled wagon to a camel; the Code of Hammurabi (rule of law); the Exodus from Egypt and the carpenter from Nazareth; the Battle of Hastings; Adam Smith’s Wealth of Nations; the American Revolution; the Crash of ’29; D Day; the integrated circuit (microchip); and we are tempted to add, subject to revision, the collapse of Lehman Brothers.*

The collapse of Lehman Brothers? You’ve got to be kidding!

OK, for impact it may not be up there with monotheism or constitutional democracy, but the recent bankruptcy of the 158-year old global financial services company does serve as a suitable icon for the collapse of the most far-reaching credit bubble in history. Only nine months in, it may be too early to fully grasp the long-term implications of the unfolding financial drama, but this is big. This is really big.

## The Main Thing

In my house we have a saying that we use to pull meandering conversations back to center: “*The main thing is to keep the main thing the main thing!*” As the FAI team comes to the office each day to sort through piles of data and opinion about everything remotely connected to investing, we have to stop frequently to regroup and ask ourselves what it all means. As we pause to let the clutter settle, it becomes increasingly clear that the stock market’s hysteria and the “green shoots” of economic recovery that get so much attention are only distractions from what really is the *main thing*.

For investment decision making in 2009, here is the main thing:

*We are living the dramatic closing chapter of a 60-year credit boom.*

*Credit fueled an unprecedented economic expansion in postwar America, rebuilt Europe and Japan and delivered much of Asia out of medieval poverty; but easy credit eventually spoiled consumers, their banks, their businesses and their governments. Now all these players are jockeying for an advantage in a world of change and experimentation on a grand scale.*

Like two-year olds, whose parents have arrived suddenly to drag them away from an unsupervised bowl of chocolates, some of us accept the end of the credit binge philosophically, as in “it was wonderful while it lasted!” Others are stashing a few last candies in our pockets and, of course, some of us are throwing a tantrum in a childish hope of distracting the disapproving adults so we can return to our delicious reverie.

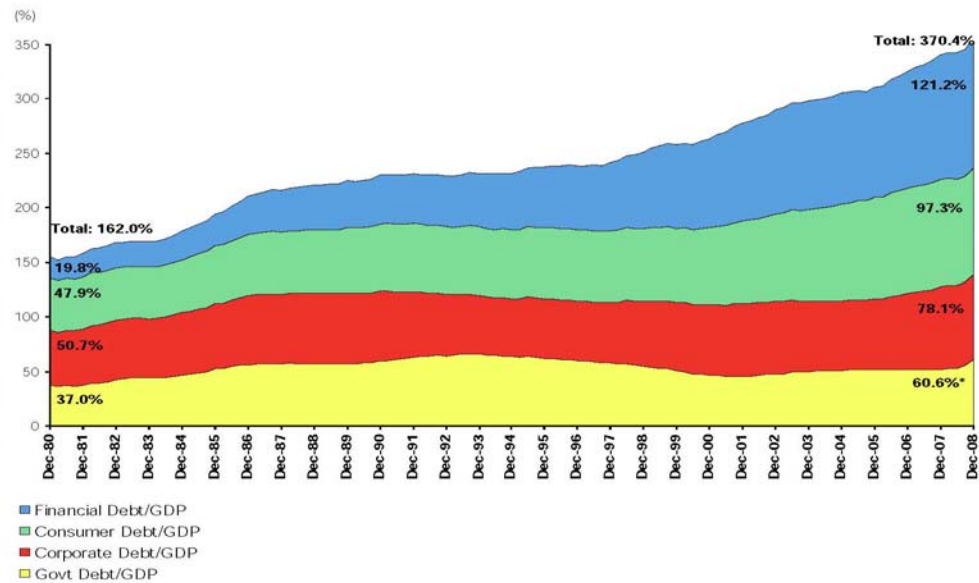
The adults in this case are not our parents, and certainly not our politicians... nor the well-tailored investment bankers who peddled foolish loans as safe securities... nor the real estate moguls who squandered investors’ money on too many malls. No, it is savers who are blowing the whistle on the biggest, wildest credit party in history; those prudent people who didn’t spend every nickel they earned and who saved all their lives, and who have watched their retirement nest egg shrink while Lehman, Bear Stearns and Citigroup ignored the signs of over-indulgence. It is these savers, the real owners of capital, who are “mad as hell and aren’t going to take it anymore!” You can see their new-found risk aversion in the flight to low-yielding treasury bonds. The party is over.

Never mind the tantrums and tears of over-indebted consumers and their pandering politicians; capital is going to have its way. It will no longer fund schemes and dreams; it will insist on sanity because now it has learned (again) what risk is. The sooner we learn to eat our broccoli the sooner we can enjoy an occasional bonbon together.

Enough of our little allegory. Following is a picture (from Lazard, Ltd.) of the last half of the 60-year credit boom; that wonderful wave of easy money that buoyed economic growth in the industrial West, funded the deflationary surge of exports from low-wage Asia, and, not to be forgotten, that fueled a generation-long bull market in stocks and bonds.

## Total Debt Outstanding Ballooned...

- Borrowers increased leverage as interest rates fell
- Debt as a percentage of U.S. GDP reached historic highs
- The only time leverage approached similar levels was in the late 1920s



As of December 31, 2008

Source: U.S. Federal Reserve, Bloomberg, U.S. Treasury Department, Social Security Administration

\* Government debt above excludes \$4.3 trillion of federal debt owned by other government entities. The largest amount excluded is that owned by the Social Security Trust Fund totaling \$2.2 trillion. Including the debt owned by other government entities, government debt/GDP was 91.0% at 12/31/08.

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Sixty years is a long cycle; long enough for consumers, businesses and governments to acclimate their behaviors to the grand life style of cheap and easy credit. And long enough for investors to believe that stable growth is an entitlement. In the first half of the expansion, from 1950 to 1980, total debt in America only crept from 1.3 times annual GDP to about 1.5 times. As we got used to living in constant debt, and grew less concerned about its risks and more addicted to growth and steady employment, over the next 30 years the debt ratio climbed faster and faster; *debt grew nearly 9% a year while GDP only grew 5.8%*. The compounding effect was phenomenal, with total debt reaching 3.7 times the country's Gross Domestic product!

Corporate, Government and Consumer debt each grew faster than the economy over the last 30 years, but the really dramatic expansion of leverage was in our financial institutions from Main Street to Wall Street... from 1980 until this year Financial debt absolutely exploded from 20% of GDP to a stunning 120%! In late 2007 the country's cumulative burden of indebtedness finally and suddenly become insupportable; the bad debt problem became visible first in the mortgage sector where for several years loans were being extended to millions of borrowers with little concern for their ability to repay. Duh! Mortgage defaults began to soar, a glut of unsold properties depressed home prices, home equity access started shutting down, and retail activity hit a wall; in response, builders, bankers and manufacturers are laying off workers across the fruited plain. The downward spiral is firmly underway. How bad is the economic downturn likely to be? How long will it take to get the economy back on its growth track? Let's take a look.

## One “L” of a Recession A true recovery may be years away!

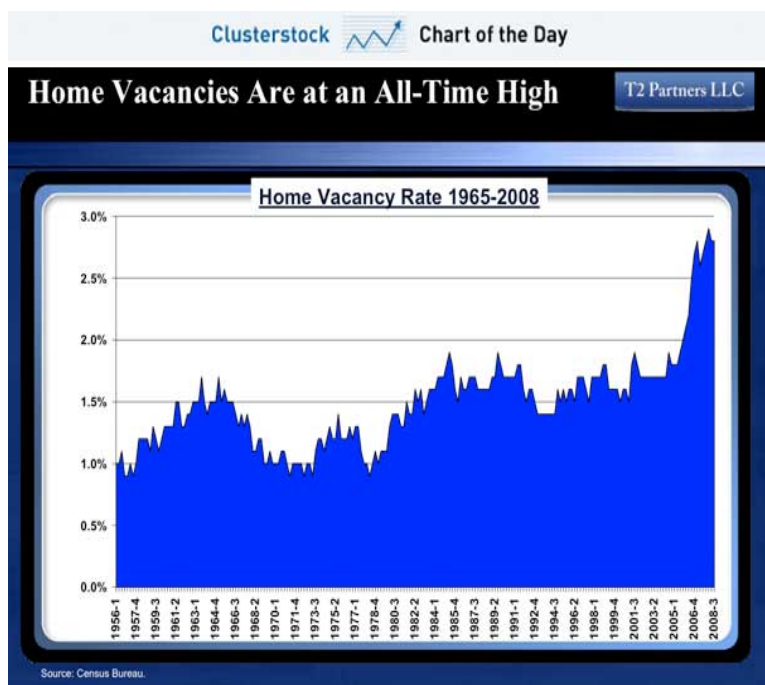
Post-WWII business-cycle recessions have been relatively mild and brief, lasting typically about 18 months from initial downturn, to improvement and on to a new high in economic activity. Each typical “V-shaped” decline and rebound cleared the system of excessive inventories, shook out a few weak competitors and skimmed the froth from the stock market’s P/E ratio. Overall, in retrospect, postwar recessions seemed rather benign and even healthy affairs. While today’s optimistic economists expect this familiar sort of “V” or at worst a “U-shaped” recovery (meaning a two-year round trip), more are beginning to imagine a double-dip or W-shaped recession and recovery.

Financial media are focused on so-called “green shoots” of economic data suggesting the cycle is already turning up. But the “encouraging” numbers that they cite are only a series of “less bad” percentage deterioration in monthly indicators like unemployment, retail sales and the expectations of CEOs. Those optimistic forecasters also take encouragement from massive government spending and aggressive monetary policies designed to reduce foreclosures and stimulate consumer spending; they assume it will have the intended effect, and in the near term it actually might, because it involves a *huge* amount of money.

We see the world a little differently. At FAI we think there is plenty of data suggesting that this economic downturn will last longer and be considerably more unpleasant than the brief recessions of the past 60 years when the credit cycle was gaining altitude. The current recession is more likely to be followed by a prolonged period of stagnation rather than a recovery... the shape will be closer to an L than a V. Housing remains an enormous impediment to a traditional recovery. Even though the building industry is only producing 25% of the number of units it was two years ago, vacancies are still twice what they used to be.

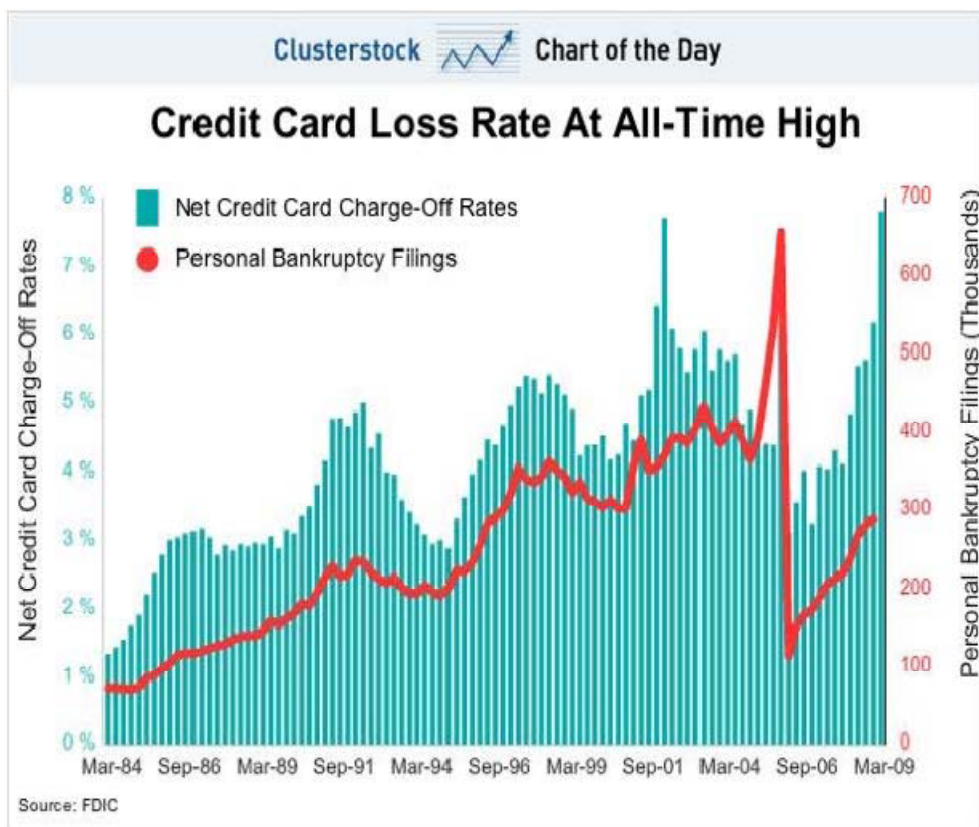
Banks have been reluctant to foreclose on homes that are long into default; if jobs don’t increase, these will eventually have to appear on the market as additional inventory. And a number of boomer homeowners who want to downsize have been waiting for the price of their McMansions to rise... we believe many will give up and finally offer their properties for sale, further depressing prices, which is a continuing drag on the consumer psyche.

The terrible loan losses of the last two years are already prompting a return to prudent standards throughout the credit industry; it is much harder to get a loan. Owners of capital have gotten the



message. They are beginning to insist on more visibility when they consider investments, and to demand higher returns to compensate for risk. In other words, capital is going to cost more in years ahead and will be available to fund only the most promising propositions. **The reduced availability and higher cost of capital will retard economic growth relative to our 30-year sojourn in the land of make believe.**

Already, factories are operating at just 65% of capacity, a low not seen in 50 years, and 9.5% of our workers have no jobs. The brutal impact on ordinary citizens is clear from the sharp rise in credit card defaults and personal bankruptcies. (See Chart Below. The 2006 distortion is a function of changes to the bankruptcy code.) Already at a record, credit card charge offs are running two and a half times what they were three years ago and seem likely to go higher as unemployment rises above 10%.



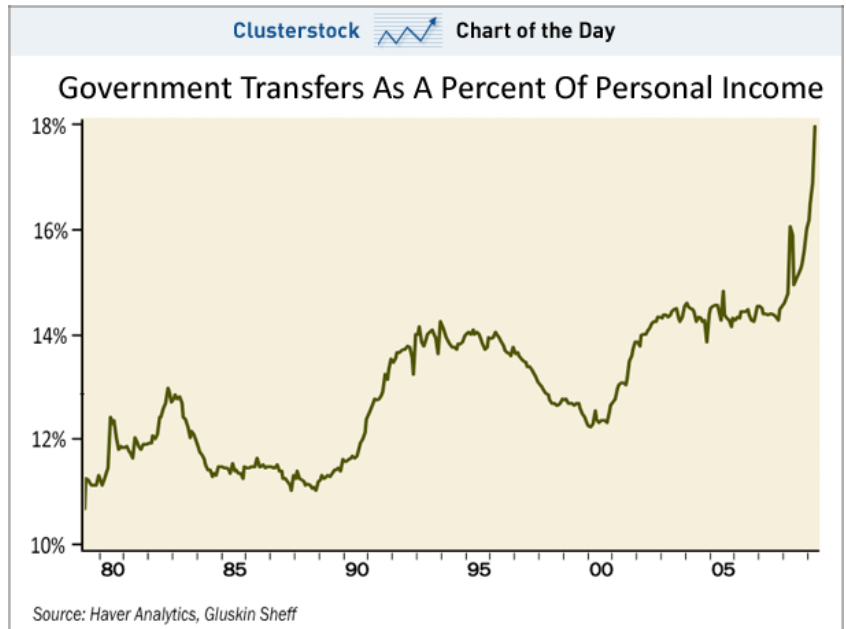
Yet, as bad as the recent news has been, **the credit contraction is not over yet.** Financial bombs are still exploding, and we think the investment community will have to endure more discouraging headlines before the dust really begins to settle. We have in mind the imbalances in state and local government budgets, the seriously underfunded condition of public and private pension plans, the non-performing mortgages remaining on banks' balance sheets that must eventually be foreclosed, the clouds gathering over the highly-leveraged world

of commercial property (new skyscrapers are still going up in Manhattan) and the coming impact on bank and insurance company capital requirements.

### **Economy on steroids**

A tidal wave of government programs designed to kick-start bank lending and create jobs could temporarily boost end demand and possibly even reduce mortgage defaults, making it appear that we're back on the straight and narrow. The chart on page 6 shows the recent surge in government transfer payments (including Social Security, welfare, financial aid, and subsidies).

Amid the sound and fury emanating from Washington, it seems appropriate to wonder about the long-term implications of multi-Trillion dollar deficits and the Federal Government's increasing intrusion into traditionally private sector activities (mortgage lending, auto manufacturing and health insurance spring to mind). Are they a plus or a minus for economic growth and expected returns on capital?



One way to express this conundrum is to ask, “Can more debt solve the problem of too much debt?” We need to keep in mind that government's only source of income with which to service its debts is tax revenue, which is declining along with GDP; and that the largess of our elected officials, beyond anything that was previously imagined, is made possible only by the fact that they can create paper money out of thin air... at least for a while. Our current working assumption is that government's financial legerdemain will at best postpone the necessary de-leveraging process and ultimately make it more painful.

Jean-Marie Eveillard (retired manager of First Eagle funds) sums up the situation best. “US consumers have been on performance-enhancing steroids, like some baseball players, and now they have been found out!” The implication is that once you're “found out” you have to go off steroids and rely on your natural abilities. The drug he is referring to, of course, is financial leverage... the mushrooming Federal deficit, the housing-based borrowing binge and the consumer's complete abandonment of savings since the last recession; and of course, the unprecedented leveraging of leading financial institutions to accommodate this widespread pretense.

There is some evidence that the consumer's withdrawal from “steroids” has begun... this year there's been a 2% contraction in household debt, the first retreat since the data began to be reported 50 years ago! This coincides with a sudden resurgence in the savings rate from zero to 6.9% of disposable income. If consumers continue to reduce their debt service costs and other spending, we could get back to the 10-12% savings rates of the 1970s and early 1980s. The economic definition of savings, of course, is “postponed consumption.” In the long run, not spending our entire income is essential to restoring economic vibrancy; but in the short run it causes unemployment! Time will tell, but the numbers suggest we may be witnessing a profound cultural metamorphosis in the direction of adult behavior!

Other financial steroids include the Government's pretenses that social benefits are guaranteed, when in fact both Medicare and Social Security have recently reported that in just a few years they'll be what the corporate world would call bankrupt! This means that collectively Americans will either have more

penurious retirements than they expected or the continuing workforce will be paying more tax than expected to support the retirees... or both!

During the peak of the credit boom, profit margins had puffed up to 50% above normal levels. Now, with little top-line growth in the US, most businesses find themselves operating in a more intensely competitive environment than they have ever seen. Corporate profits fell sharply last year and are still falling at a -35% pace this year. In a flat-to-shrinking economy, scrambling for market share is, for most businesses, the only feasible path to growth. You can see the effect at the retail level, where price competition has been fierce and empty stores are a fact of life. It would not surprise us to see overall corporate earnings eventually stabilize around 40% to 50% below their recent cyclical peak. Current stock prices, however, contemplate a much more benign earnings outlook.

The very pleasant 30% recovery in US stock prices from the early March lows seems to have been based on the hope that the recession will have run its course by Fall of 2009, and that with a boost from government spending and transfer payments shoppers will rediscover their mojo. The Financial Advantage point of view is that a longer-lasting downturn in the credit cycle is underway, and that this will dampen consumer spending, stimulate the savings instinct, limit economic growth, raise the risk-free rate of interest, give banks the heebee geebees and reduce business profit margins.

**If this turns out to be a reasonably accurate description of reality, successful investing is going to require a less equity-centric portfolio structure and a more tactical investment style than during the ascending phase of the credit cycle when a rising tide of consumption was lifting most of the business barges.**

**Creative Destruction...the rocky path to a brighter future!**

*The inevitable and ultimately beneficial de-leveraging phase of a long credit cycle is clearly underway. A more sober reality is settling upon the land. Bad loans will be written off; old factories and malls will close. But from the ashes of disappointment will spring the opportunities of a new generation.*

As Joseph Schumpeter observed in *Capitalism, Socialism and Democracy* (1942), capitalism as a system is by nature adaptive to its environment. Not only it is never stationary but actually it *cannot be stationary* since the environment to which it adapts is always changing. “The fundamental power that sets and keeps the capitalist engine in motion comes from new consumers” (think for example of the hundreds of millions of humans in India, China, Brazil and Eastern Europe straining to experience a “middle class” standard of living), “new goods” (iPhones, face book, GPS, unmanned aircraft), “new methods of production” (biotech, nanotech, solar power, natural gas from shale) “or transportation” (hybrid cars; LNG tankers), “new markets” (eBay) “and new forms of industrial organization that capitalist enterprise creates” (Costco and BJ’s; mortgage securitization...oops!).

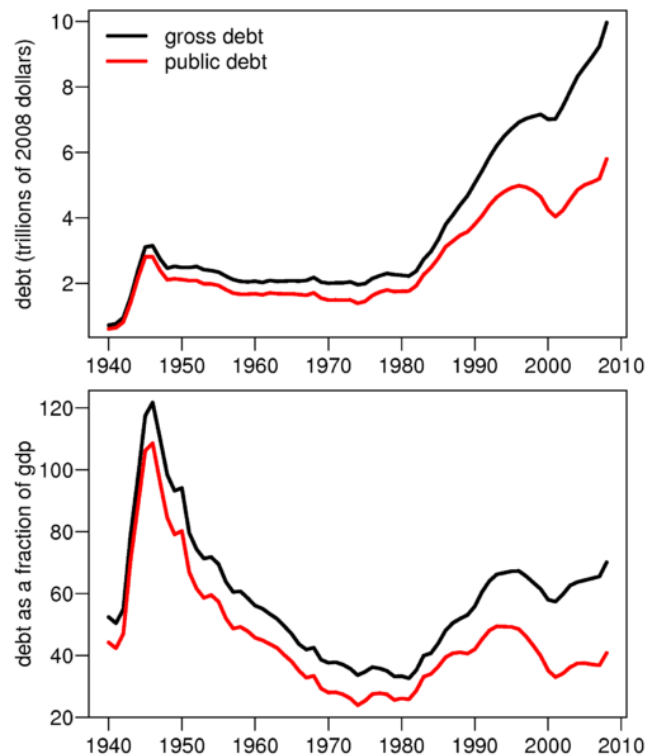
It is Schumpeter who coined the expression, “Creative destruction” to describe capitalism’s habit of abandoning those portions of our economic system that have become obsolete or inefficient, and

supporting instead the new & the improved. It is endless innovation springing from the minds of free citizens and funded by their savings that keeps driving our standard of living higher, generation after generation. Sure, there are disruptions and dislocations and personal losses during messy transitions like the current one. The ongoing challenge for us as human beings is to organize our society in a way that shares the pain as well as the benefits without eliminating the personal incentives that make capitalism work.

To what extent is that government's role? How is it doing? That's a philosophical question well beyond the scope of this humble essay; but to understand where we are in the cycle of creative destruction and regeneration we do need to touch on government's rather dramatic financial response to the current recession. In short, Congress is eagerly approving massive borrowing and record spending in an attempt to thwart the de-leveraging process because a) the current political majority believes it is government's proper role to stabilize employment, and they believe debt will achieve it; b) it is the natural instinct of professional politicians to create programs that might enhance their career prospects, and a "crisis" presents a perfect opportunity to impress the electorate; and c) as the world's largest debtor, the US Government dreads deflation, but fortunately they are in a good position to create the antidote... inflation.

This chart shows the history of total Federal debt from 1940 (exaggerated by WWII) through fiscal 2008 ("Gross Debt" includes government IOUs to the Social Security Trust Fund).

*Projections for fiscal 2009, '10 and '11 show federal gross debt soaring from \$10 Trillion to \$15.7 Trillion; that is, from 70% of GDP to 101% in just three years!* And this is assuming near-normal GDP growth. Is it any wonder that rating services are putting the US currency on credit watch?



Federal "jobs creation" programs, and distributing government checks to shore up consumer spending, and raising taxes on people with above-average incomes all distort ordinary market signals. The natural process of creative destruction is also thwarted by programs specifically designed to prevent poorly managed enterprises from failing and being replaced in a sort of corporate Darwinism by businesses better able to adapt to change. The classical view of economics is that businesses guided by bureaucracies, especially ones with non-business instincts and incentives, are unlikely a) to attract private capital or b) to succeed in satisfying the product and service demands of a free market. In nearby years there will be plenty of this kind of government experimentation for investors to examine and deal with.

*As investment managers, our present expectation is that the drift of public policy is toward taxpayer funding of large, inept organizations in several industries that we would rather avoid until government policies become more supportive of free markets.*

Of course, a massive government policy response to the recession is characteristic of the entire industrialized world, not just the US. Whether it will avert a disaster or cause longer-term unintended consequences such as hyperinflation, competitive currency devaluation and heightened geo-political tension will only clarify with time. We will devote space to these critical international forces in future issues of the *Blue Sheets*<sup>®</sup>

## ***Our Investment Response: Be Wary, Patient and Creative***

My sister, Gerry, is a talented singer, actor, and photographer; to succeed in these creative, non-mainstream businesses over the years, she has developed an array of practical survival instincts that I think investors could profitably imitate.

Years ago when Gerry was the quintessential “starving actress” she waited tables at O’Neal’s Balloon, a trendy white table cloth eatery just off Central Park West. I remember her telling me that when taking customers’ orders she would kneel next to their table so she could face them at eye level when answering questions about the menu. She said her tips were much more generous when she made this friendly adjustment to her service style. Then, late at night she’d walk home along less-than-posh Ninth Avenue sparsely populated in the wee hours by some homeless folks and a few neighborhood characters that walked a little unsteadily as they sipped from their pints. I’ll always remember Gerry describing how she would “act like a nut” as she walked through the “iffier” areas, bobbing her head, mumbling out loud and occasionally jumping up to kick the wall of an apartment building! Her antics put the night people on notice that they should keep their distance! No one ever bothered her.

The investment lesson? Simply that it’s often appropriate to adapt our behavior to changes in our environment. It can be helpful to both our prosperity and our security. We think the global securities markets these days are more like a poorly lit city street at night than like your neighborhood restaurant where you can relax. Not that you have to “act like a nut”, but it seems a good time to be creative and a little more wary than in the years before the bursting credit bubble began to impose its discipline.

With that in mind, following are some of our ideas for adapting to new risks and new opportunities during what may be *several years of transition*. At Financial Advantage, it will remain our daily mission to examine fresh ideas for diversifying our clients’ portfolios, for sidestepping the traps and for generating positive returns even as the economy shrinks its debt load, shuts its least efficient businesses, and copes with an array of political experimentations.

## Diversification

We've long maintained that the most valuable service an investment advisor can render his or her client is to be sure their investments are well diversified. To be diversified means that not all the investments are subject to the same influences... neither the same risks nor the same opportunities. Any investment, even the simplest one, is by nature exposed to unknown future developments. Unless you are prepared to "bet the farm" on this or that possible development, it makes sense to spread your investments across a range of uncertainties. George Roche, retired Chairman of T. Rowe Price, said it well: "You don't *get* rich by diversifying; but you *stay* rich by diversifying!" We are in the business of helping people preserve their prosperity, so we diversify.

There are essentially four classes of investable assets:

1. **Cash equivalents** such as currency, bank deposits, money market funds and treasury bills.
2. **Bonds**, i.e. loans made to businesses or governments with contractual terms regarding debt service and repayment.
3. **Stocks**, which represent full or fractional ownership of businesses, with limited liability.
4. **Physical assets** such as commodities, buildings, equipment and land.

Each of these four has very different investment characteristics and is useful for diversifying the risks in a portfolio and for achieving exposure to a spectrum of investment opportunities. Each tends to have its day in the sun from time to time.

There have long existed variations on these four such as *options* to buy or sell stocks, *warrants* to purchase stocks or bonds, *leases* on real estate and *futures contracts* to deliver or take delivery of crops and metals. These are called "derivatives" because they derive their value primarily from the worth of an underlying asset to which they refer. In our digital age, a dazzling array of derivative securities has been developed and accepted widely as tradable investments. Examples include index options, ETFs and inverse funds.

Derivatives tend to be much more volatile in price than the underlying asset, and this aspect makes them popular as speculative instruments. However, when derivatives enjoy broad acceptance, deep markets and transparent pricing they are also useful for managing a portfolio's exposure among the four basic asset classes while putting less of the portfolio's value at risk. They are a practical tool.

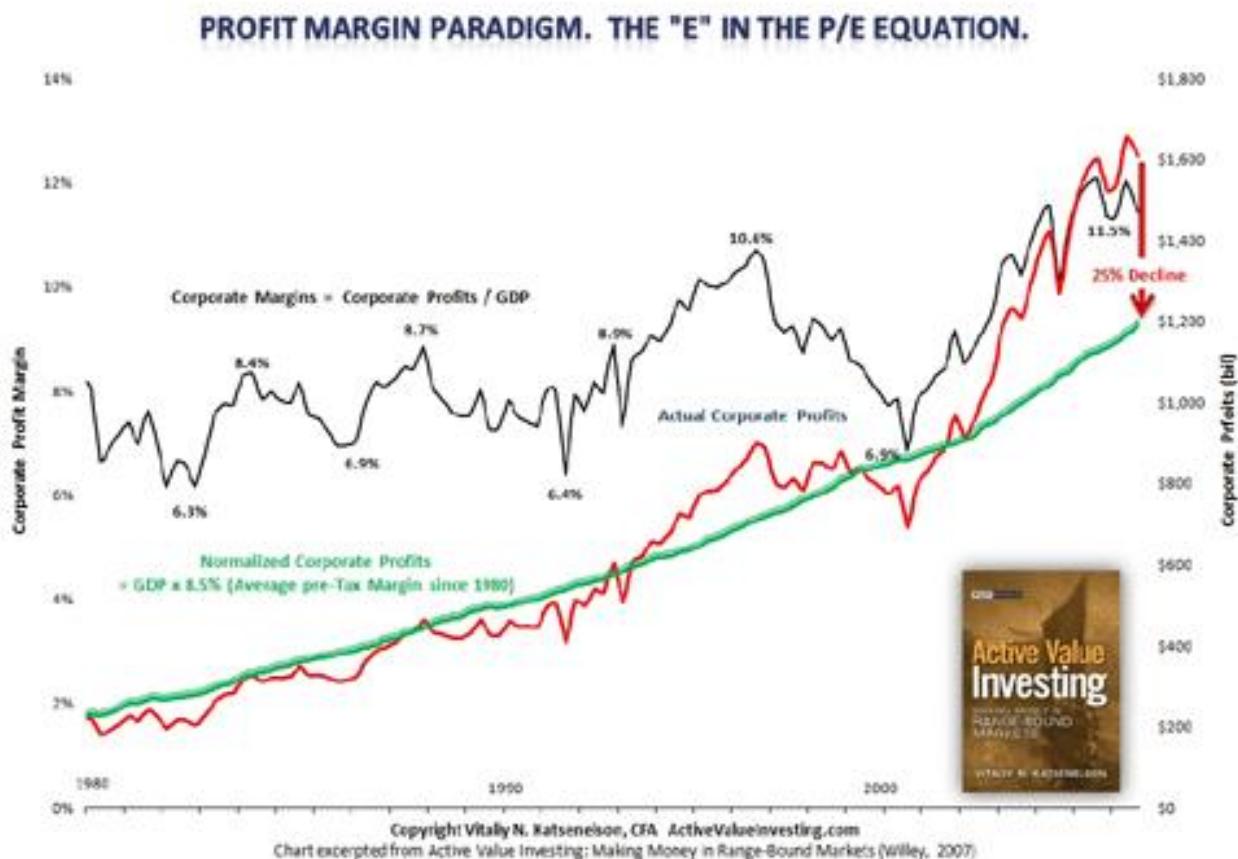
The long bull market that ended in 2000 (and again in 2007!) nurtured the widely-held notion that, "All but the most conservative portfolios should be weighted in favor of *stocks* because over time stocks earn more than bonds." But a recent Wall Street Journal story noted that "stocks have underperformed government bonds in the past 5, 10, 20 and 30-year periods! Hmmm. In fairness to "widely-held notions," we should point out that stock returns for all those time periods were highly influenced by the losses of the past year.

Most advisors still counsel investors to "stay in the game" so they do not miss the upturn in the stock market. By this they usually mean to maintain the traditional emphasis on stocks in their portfolios (60%-70% is a common equity allocation). Well, that was certainly good advice in the great bull market of 1981-

2000; and as long as public policy supports an innovation-seeking free market system equity will eventually out-earn bonds again. But before we can set the table for the next Entrepreneurs' Ball, we have a lot of cleaning up to do from the last party that got a little out of control!

*For now, we think there is still a lot of risk in stocks. Expectations for a broad earnings recovery are backward-looking, and are naive with respect to the likely magnitude and duration of the consumer retrenchment that has begun.*

Ours is a consumer economy like none other in history...consumers sop up 71% of the nation's output of goods and services. Supercharged by savings draw-downs and home equity loans, this figure is up from just 61% not that long ago. In an economy where that frothy 10% increase is beginning to evaporate, and where the manufacturing and service industries are shrinking to fit the reduced demand, sales growth is going to be hard to come by for most US businesses. Profits? Even harder. In the chart below, see how pretax profits soared under optimum consumer spending conditions to about 12% of GDP. Just settling back to the earlier normal of 8% might bring a sigh of relief to CEOs, but we don't think this sort of adjustment is yet priced into stocks.



## *A look inside our Model Portfolio*

### **We are way underweight stocks**

“Reported earnings” for the S&P 500 index peaked in June 2007 at \$84.95; the index traded at 1503 for a trailing Price/Earnings ratio of 17.8. Estimated “reported earnings” for the current year are \$28.65! For 2010, analysts are assuming a big gain of 32% to \$37.81. The index is now trading at 879 or 23 times that 2010 earnings estimate. That’s expensive in anybody’s book. For reference, bear markets in the 20<sup>th</sup> century tended to bottom at a P/E of less than 10.

Some say stocks are not expensive because they are focused on estimated “operating earnings” for 2010, which does not count so-called non-recurring write-offs and losses related to discontinued operations. Estimated “operating earnings” for 2010 are nearly twice the “reported earnings” estimate, making the index just 12 times earnings on that metric.

We think reported earnings are the real deal and the figure shareholders care about. It seems gratuitous to exclude as not meaningful certain actual losses that accountants choose to designate as non-recurring. A loss is a loss, and it says something about the company that incurred it. A stock’s price represents the present value of expected future earnings; losses, whether “recurring” or “non-recurring”, are not earnings.

*We conclude that stocks remain overpriced for the changing world we are living in, and we prefer that they not outweigh other asset classes in our portfolios until they are more realistically priced. Nevertheless, because the ownership of businesses offers the greatest profit potential in the long run, and because future developments could turn out better than we currently anticipate, we will continue to invest part of our portfolios in stocks, making every effort to be selective and price-sensitive. Our “B” model was recently invested only about 25% in stocks, almost half of which was offset by hedge positions.*

### **Emphasize cash income**

If stock price appreciation is going to be hard to come by, where can capital earn a return? Our first choice is up-front cash returns from interest (on cash-equivalents and bonds) and dividends (from stocks). The good news is that these streams of income are much more stable than stock prices; the bad news is that high quality interest and dividends yields are pretty skinny these days.

Money market funds pay a small fraction of 1%! Treasury bills, the same. This is so because a lot of investment capital has flowed into these safer assets simply to avoid principal losses. Did we mention that the world is a dangerous place? We aren’t the only people to have noticed it! So, we have reduced our cash positions over the past year and we are trying to maintain a cash level that will just accommodate client cash needs and trading liquidity.

Where we are willing to take a little more *credit risk* by owning bonds of highly-rated corporate borrowers, we can earn a better return. And if we are willing to take a little more *inflation risk* by owning bonds with maturities 10 or 20 years in the future, we can get even better interest income.

*In the “Stable” section of our “B” model, we have about 30% of the money invested in a variety of short-to-medium term high quality bonds with interest yields of about 4%. Not very exciting, but steady! And when the time comes, this money will be easily accessible for higher-opportunity investments.*

*In the Opportunistic portion of the model where we can take on some credit risk and inflation risk, we have 23% invested in an eclectic mix of income securities: public utility stocks, Canadian natural gas stocks, longer-term corporate bonds, senior floating rate corporate loans and inflation-protected US Gov’t bonds (TIPS). The cash yield on this carefully-selected collection is nearly 7%. Including price appreciation, the total return from this group was much better than that in the first half of this year.*

### **Defending Against Inflation/Deflation Risks**

In the event that the government’s fiscal and monetary policies do cause inflation after a year or two, as we expect, and based on our working assumption that it is politically unlikely that we’ll see stimulus withdrawn in a timely fashion, it is probable that the prices of internationally-traded essential commodities like fuel and grains as well as gold will rise. It is to protect against this de-facto currency devaluation that we presently have 8% of our “B” model invested in gold bullion in addition to about 6% in the stocks of politically secure, financially strong energy producers. It is also the reason that a lion’s share of our bond holdings are of very short duration; this limits our principal risk and gives us the flexibility to reinvest in higher-yielding bonds if and when inflation starts to drive up interest rates.

We think of our hefty gold position not just as a US inflation hedge but a hedge against the devaluation of all paper currencies, the Dollar as well as the Euro, Yen, Swiss Franc and Pound Sterling. The US is the epicenter of the credit crisis, but the problem extends across Europe as well... the UK and Switzerland as well as the 16 member nations of the Euro zone. All five of these central banks are expanding money supplies and their governments are taking extraordinary fiscal measures to shore up lenders and support consumer spending lest their heavily indebted economies plunge into a self-reinforcing downward spiral. They all seem to be aware of the modern significance of Irving Fisher’s 1933 debt deflation theory; it proposes that the only practical way to stop a devastating spiral of debt defaults and economic contraction is by sponsoring reflation.

***Our concern as investors is two-sided: a) Since it is clear that governments in the industrialized world are hell-bent on reflation (devaluing their currencies) what is the best way to defend the buying power of our clients’ dollar-denominated portfolios? and b) What if the reflation efforts fail, as they did so spectacularly in Japan during the past two decades?***

To get some sense of the *global* ramifications of this credit crisis, you need to realize that although the US population totals just 5% of the people in the world, the free men and women of our fair land generate

25% of the whole world's output of goods and services! And ours is the currency in which most global trade is denominated. Perhaps even more important is the fact that since the Bretton Woods international currency agreement in 1944, the US dollar has been accepted and relied upon as the reserve currency for the world; it constitutes almost 2/3 of the foreign currency reserves in the world's central banks!

Since 1971 when it was unilaterally decided that the dollar would no longer be convertible into gold at a fixed rate, the value of the Buck has depended solely on the "full faith and credit" of the U.S. government. Here we should remind ourselves that the government's credit is dependent on the prosperity and credit-worthiness of the U.S. consumer from whom it draws its tax revenue. Spending by the over-leveraged US consumer makes up 71% of our National GDP and that is why the government's advisors so desperately fear a consumer retrenchment that could further depress asset prices, accelerate defaults and launch an unstoppable debt deflation spiral.

Better informed people than we have no idea how this high stakes game of "chicken" will end...

- a) In rapidly rising US inflation; perhaps even hyperinflation?
- b) In a currency devaluation contest among nations desperate to maintain their exports?
- c) In Fisher's dreaded debt deflation that crushes the over-leveraged economies of the West and ushers in Asia's triumphant century? or
- d) In some unimaginable moment of bureaucratic prescience that perfectly times a stimulus reduction to coincide with the emergence of a self-sustaining consumer recovery!

The last choice, while devoutly to be preferred, is at best a *very* remote possibility. Advisors to bureaucrats and politicians know that a premature tightening in 1937 prolonged the Great Depression, and this will be their rationale for not removing the punchbowl just as the fun is resuming. If we are lucky enough to get that far down the road, inflation will be our lot.

*And so, for the time being, our official expectation is the second best outcome, the inflation scenario that Japan was unable to achieve despite its best efforts. In 1990 Japan was a nation of savers with an aging demographic and net emigration. The United States does not share those deflationary characteristics (except for our aging boomer generation) so perhaps our intentional reflation could succeed.*

*While we have built our portfolios for this expectation, deflation remains a realistic possibility. We know we need to be prepared to radically change the makeup of the portfolios if and when it looks as though reflation is not going to work.*

Included among our various fixed-income securities, about 8% of the portfolio is invested in Treasury Inflation Protected Securities, some directly and some through mutual funds. TIPS are a unique investment vehicle combining the security of the US Treasury credit rating with a fixed coupon *plus* an additional stream of income that matches the CPI each year! Because of the high credit quality and the inflation protection, the coupon yield alone is pretty low... in the 1% to 2% area depending on how far out the maturity is.

Every year that the CPI rises, a TIPS' redemption value is increased by the same percentage; if CPI is +3%, then the face value of the bond goes from, say, \$1,000 to \$1030. *And*, the annual interest payment based on the coupon rate goes up because the coupon is applied to the increased redemption value, not to the original face value. So that's how both income and principal are protected against inflation. What about deflation?

Deflation, an environment of generally falling prices for goods and services, is *very* difficult for most businesses and traumatic for borrowers and their creditors. Here is why some TIPS would be a better bond investment in a deflationary setting than, say, corporate bonds. Each year of negative CPI (as in *minus* 2%) the TIPS' redemption value is *reduced* by that percentage. A \$1000 bond issued 10 years ago that had grown to a redemption value of, say, \$1300 would be reduced to \$1274. No defense there! **HOWEVER**, the rules say that the redemption value cannot be reduced below the issue value of \$1000. So, recently-issued TIPS will keep paying their coupon, *won't* have their redemption value reduced during deflation, *but their buying power will be growing!* Now *that's* a defense.

### **The Creativity Part**

The foregoing look inside our model portfolio describes nearly  $\frac{3}{4}$  of our portfolio assets (cash, various income securities, stocks & stock market hedges and gold). The remaining quarter of the model portfolio showcases our best creative efforts to earn a positive return while the traditional securities markets are either not helping or actually working against stock and bond investors.

We recently redesigned our diversification flowchart to better describe the variety of investment tools we have at our disposal and show how they are differentiated one from another. This chart appears on page 18. The three boxes that differ most from traditional investments are **Tactical, Long-short, and Hedge Strategies**.

**Tactical...** With the world economy struggling and the overall direction of stock prices likely to be sideways or down for an extended period of time, it will be hard to make money the traditional way of buying stocks of successful businesses and holding them for the long haul. It is fine to be patient, but with cash reserves paying almost nothing, and with the specter of inflation looming, we think it is prudent to learn profitable ways to adapt; to work with modest, calculated risks in a small part of the portfolio in an effort to build positive returns brick by brick.

While the global credit contraction is producing economic turmoil, which is certainly no fun, it has also produced a useful new market characteristic... exaggerated price volatility for stocks, bonds and commodities. Today's unusually wide price swings, both up and down, present opportunities to add modest increments to the portfolio's total return by trading more actively in a small part of our portfolio.

One example is active rebalancing. For instance, this year our position in Cerner, a medical information technology business, soared 60% in a few months. We love the company, but not at any price! The sudden price increase seemed to reflect public excitement based on Washington's flogging the

opportunities for electronic patient information and digitized Physicians Order Entry to reduce healthcare costs. Rather than ignore the sudden price move, we sold about a third of our holding, taking it back to our original percentage allocation, and said, “Thank you, Mr. Market.” That simple move captured a 0.4% increment to the portfolio return, which is a lot better than watching the stock rise and then fall back. If enthusiasm for this sector cools and we get another buying opportunity in Cerner, we’ll act on that! That’s one example of a Tactical investment action.

Here’s another... “Paired Trades”. Sounds mysterious, but it’s really not. A few months back we observed that the spread between treasury interest rates and the interest rates on investment grade corporate bonds was far wider than usual; like 7 percentage points rather than 1 or 2%. So we made the following two trades as a pair: sold short the 30-year Treasury bond (if treasury rates rise, their price will fall) and bought a mutual fund invested in Investment Grade corporate, (if their interest rate falls, their price will rise.) The idea of making both these investments at the same time is that we don’t have to guess which way the spread will close; whether treasury rates rise or corporate rates fall or both, as long as the spread returns to normal we make money. When the spread is no longer distorted we’ll remove this trade. It is only a tactical opportunity. (As it turns out in the first half of this year we made 31% on one side of this paired-trade and 21% on the other side! And it did not depend at all on the direction of the stock market!)

**Long-Short...** Investments in this non-traditional box include the Hussman Fund and the Rydex Managed Futures Fund. When we invest client money in a mutual fund as part of our total portfolio structure we are, in effect, delegating a specialized task to the professionals that run those funds. John Hussman has a long track record of success in managing a public stock mutual fund portfolio against which he writes put and call options to control the portfolio’s exposure to market risk. The portfolio is never net short but frequently neutral. He publishes a detailed weekly commentary on his strategy which our clients can access at [www.hussmanfunds.com](http://www.hussmanfunds.com).

Futures contracts on commodities and currencies are one of the oldest versions of derivative securities. They are used widely and the markets are typically deep and liquid. The Rydex Managed Futures Fund is a portfolio of futures contracts on a wide range of commodities and currencies. Some are “short” and some are “long”, depending on whether the recent contract price is above or below a moving average. It is purely quantitative based on historic price behaviors, involving little in the way of human judgment. The formulae have produced steady, unspectacular returns unrelated to stock and bond market performance.

**Hedge Strategies...** “Hedging” is a strategy designed to minimize exposure to certain risks without eliminating the investment position that exhibits the risk in question. We currently have three different kinds of hedge investments which we use tactically to limit three kinds of risk...stock market risk, currency risk and inflation risk.

We have described earlier in this issue our reasons for concern about overall stock market risk. Since we think this is a concern that could be present for a year or more, we have invested about 3% of the model in the Prudent Bear Fund which we expect to maintain into the foreseeable future as long as stocks appear overpriced. This fund is not always 100% short the market; rather the managers reduce their short

allocation during strong market rallies... they call it, "Not fighting the tape." Their active management of the short position has provided better returns than a 100% short fund like Grizzly (which we used to own). When there has been a significant rally in stocks, we may from time to time also make a small temporary investment in a bear fund like the ProShares Ultrashort Russell, but this would be in the Tactical box since it would be by intention a short-term, opportunistic position.

Hedges against currency risks are built into the Managed Futures Fund portfolio in the form of dollar and non-dollar futures contracts as well as our significant holding in GLD, which is an Exchange-Traded mutual fund (ETF) that owns gold bullion.

## Summary

In this longer-than-usual issue of the Blue Sheets® we've shared our ideas and policy on three core topics of significance to our clients' investments:

- A) That a phenomenally influential 60-year credit cycle has ended explosively, and it will probably take years for the disruptions to be sorted out.
- B) That the current recession is unlikely to resolve itself into the kind of energetic recovery we have been used to during the long accommodative phase of the credit cycle.
- C) A review of the strategies we have developed for protecting assets and achieving positive returns amid an extended period of economic stagnation and political experimentation.

The Financial Advantage staff is energized by the challenges of this unusual economic era and vigilant for the new opportunities that free market innovations will inevitably produce!

*For the Investment Committee:*

J. Michael Martin, J.D., CFP

July 14, 2009

**DJIA** 8347    **S&P 500** 904    **NASDAQ** 1798    **30-yr Treasury** 4.32%

# STABLE & OPPORTUNISTIC PORTFOLIO CONSTRUCTION

