



FINANCIAL ADVANTAGE, Inc.®

*for a better life®*

## The *Blue Sheets*®

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

*Autumn 2007*

### ***“Stability Breeds Instability”***



*Hyman Minsky (1919-1996)*

#### **Complacency suddenly evaporates**

To grasp what’s really behind the wild swings in the financial markets the past few months, we need only ponder our headline insight from Hyman Minsky, an American economist who focused his work on understanding the characteristics of asset bubbles and the financial crises that inevitably follow them; for in fact this is the very circumstance in which we now find ourselves.

Minsky studied the relationship between the economy, which usually changes course slowly, rather like a battleship, and the financial markets, which can flit like a butterfly on drugs. During long periods of economic prosperity, Professor Minsky observed, lenders and investors tend to let their guard down. Gradually they become oblivious to risk simply because nothing awful has happened to them in a long time. They feel wise, competent, and bullet-proof. They tend to get a little greedy, eschew normal safeguards and to keep bidding up assets in expectation of continuing success in their inspired endeavors.

This progression from normal caution to complacency and then greed often leads to the use of borrowed money to multiply otherwise boring returns from fully-priced securities. For example, a fund manager might find that she can earn a pedestrian 6% or \$600,000 from a \$10 million pool of mortgages. But if she can borrow an additional \$10 million cheaply in the short-term market (say, at 1.5% in Tokyo) she can buy twice as much of that mortgage pool and, after interest cost, net an extra \$450,000 for her investors. Nice. But, hey, why be timid? Why not borrow \$100 million and earn an extra \$4.5 million after interest costs?! Now her initial \$10 million of invested capital is making a very exciting 50% annual return. Now that’s being smart, right?

Minsky probably did not know it, but in describing the cycle from normalcy to careless, leveraged investing he was effectively predicting the emergence of modern hedge funds (10-1 leverage is not uncommon); also consistent with his observation is the recent prevalence of 100% loan-to-value mortgage loans to borrowers who may or may not have jobs (aka “Alt-A mortgages” or “liar loans”, which account for a double-digit share of mortgages issued in recent years). But even the Professor would have been surprised by the financial alchemy that has helped create AAA-rated mortgage backed securities out of a hodge-podge of lower-rated loans that could only be marketed in an era dominated by swash-buckling speculators such as we have experienced recently.

So, is it a smart idea to leverage up 10-1? Well, sure, if none of the variables suddenly go against you; such as a rise in short-term interest rates or appreciation of the currency you borrowed in and must eventually buy to repay your loan. Or, a possibility that never seems to occur to investors during the complacency phase of Minsky's cycle, if the asset you bought with all that borrowed money suddenly shrinks in value! Try thinking *shrink times ten* and you'll start to understand something about fear. If \$110 million of mortgages (our previous example) shrinks in value by just 10%, that's an \$11 million paper loss... more than wiping out our hedge fund heroine's \$10 million of original investment; a *total loss* for the equity investors. *Total, as in nothing left!*

This summer, the prosperous-complacent-greedy-smart-leveraged crowd hit a speed bump when billions of dollars of *defaults in sub-prime mortgages* suddenly injected this kind of *fear* into the equation. Credit markets seized up almost overnight. Hundreds of mortgage providers had to close their doors, a few hedge funds went under, and there was even a run on a bank in London for the first time since Victoria was Queen! And the Dow Jones Industrial Average suffered its first 10% decline in about 5 years.

Alas, the ownership of ill-fated mortgage-backed securities did not stop at U.S. shores, since holders of the huge and growing US Dollar deposits around the world had been successfully solicited by Wall Street's dream weavers. To quell the sudden panic in securities markets when mortgage defaults ensued, central banks in France, Germany, the U.K. as well as the U.S. instinctively pumped hundreds of billions of dollars, euros and pounds sterling into their banking systems to literally keep the doors open to normal commercial lending activity, so widespread was the disruption.

Washington dispatched sincere government spokesmen to power lunches and the evening news shows to reassure the public that the "sub-prime mortgage crisis is being contained to a small part of the financial market". In September, the Federal Reserve chopped the Fed Funds rate by a ½% to 4.75%. With investors' long-prevailing optimism thus re-confirmed by word ("don't worry") and deed ("here's some cheap money and there's more

where that came from"), the credit market panic evaporated like a morning mist! As though Harry Potter had pointed his wand at the NYSE and shouted "Reparo", the stock market began to heal itself before our eyes! Investors piled back into stocks and within 6 weeks the Dow and S&P 500 were making new highs!

Will the crisis blow over as we're told to believe by those whose job it is to prevent panic? Will government be able to smooth things over with modern fiscal and monetary tools? Perhaps. But after the Fed's further 25 basis point cut in November, stocks have begun to fade rather convincingly, suggesting that skepticism may be getting a foothold.

***There is a great deal of evidence that the problem is not just granting loans to unemployed people. Rather, and this is the understanding on which we have built the FAI investment strategy, the problem is a long, broad reliance on borrowing of historic proportions; a fragile, unsustainable state of affairs.***

Professor Minsky teaches that the correction of a long debt cycle inevitably includes widespread write-offs of imprudent loans and a general contraction of credit availability as lenders reappraise risks and would-be borrowers (at least the solvent type) reconsider the prudence of taking on more obligations. Such a cyclical cooling of the credit environment seems to have already commenced. If so, and we should know for sure in the next 6-12 months, we would expect to see sobriety re-imposed upon the ranks of U.S. consumer-borrowers as well as investor-borrowers (did we mention that margin loans on Wall Street are at an all-time high, and that the cost of repaying a Yen loan has risen by 15% in 3 months?)

The financial landscape may become temporarily littered with casualties as markets in the industrial nations are hammered back to normalcy, and as securities markets re-price to sensible long-term expectations; none of which would be a surprise to Professor Minsky.

## **FAI investment themes provide both *offense* and *defense***

In March 2005 we described five realities that we believed would influence capital flows around the world for a long time. We have been using these *investment themes* to structure our search for undervalued asset classes or securities during the past three years.

These themes also help us identify investments we should be *avoiding*, the defensive part of our portfolio strategy. Below are listed the investment themes as we presented them three years ago. We have found them very useful but not all that easy to remember. So we have renamed the themes slightly to form an acronym that will help keep them in mind as we (almost daily) review current economic and political developments in the light of these enduring themes. Our newly-named five themes spell PEACE, a condition devoutly desired by all persons of good will, conducive to harmonious living and, of course, prosperity. (And easy to remember!)

### Original FAI Themes

- P/E Contraction
- Debt Leverage
- Drive for economic freedom
- Decline of oil production
- Demographics

### Renamed FAI Themes

- P/E Contraction
- Energy constraints
- Aging Populations
- Credit constraints
- Emerging Nations

In this issue of the *Blue Sheets* we will begin revisiting our themes, to examine whether they remain useful or are perhaps changing somewhat as forces in the capital markets, and whether they may need some updating. Drilling down below the themes, we'll ponder a) whether the investments they have guided us to are still appropriate, and b) what new investments our themes may be suggesting in today's environment. Our re-

examination will span the next several issues of the Blue Sheets.

Let's start with the first theme, which posits that we have entered what is likely to be a prolonged period during which stock valuations (in terms of their Price/Earnings ratio) contract from the extraordinary levels reached in the technology boom of the late 1990s.

### **P/E Contraction theme**

Based on a 100-year history of US stock market cycles, this theme posits a long period of time, perhaps 10-15 years or more, during which the Price-to-Earnings ratio of stocks generally shrinks from the highs established at the top of the last secular bull market (1981-2000). Indeed this has been playing out, with current valuations for the S&P 500 at 17.3 X trailing 12 month earnings, well below the 30X range which it regularly inhabited as the market topped out in 1999-2000.

However, the shrinking P/E did not prevent stock prices from rising because rapid earnings growth (the E in P/E) more than offset the decline in P/E ratios. Some analysts with optimistic earnings estimates for 2008 say that the contraction in P/E ratios has run its course and that stocks are a very good value. We have a different point of view.

John Hussman (the Hussman Funds) has done the heavy lifting to determine how stocks have been valued over the years in relation not just to the current earnings per share (EPS) but in relation to the entire *earnings cycle*. You can read his work for yourself at [www.hussmanfunds.com](http://www.hussmanfunds.com); check the archives for his Weekly Commentary and you will see many provocative articles, replete with data and graphs that explain how he normalizes the historic P/E experience for the position of then-current earnings in the long-term earnings cycle.

As John explains, over time the market has tended to sell at about 10 X earnings when corporate profit margins are high in their historic range. Even though margins are currently at all-time highs, the P/E is 17-18X, making stocks seem pretty rich by

historical norms, not cheap as Wall Street would have us believe.

So we remain comfortable with the relevance of the long-term P/E contraction theme which we first espoused in 2004, and we believe that the bursting of the credit bubble will help deflate investor optimism and contribute to the P/E contraction process. (For a full discussion of this theme see our archived Blue Sheets for December 2004 and Winter 2005 on our website at [www.FinancialAdvantageInc.com](http://www.FinancialAdvantageInc.com); also see John Mauldin's excellent treatment of this subject in "Bull's Eye Investing", available through Amazon.)

*When the country enters its next recession, which could be in the next 6 months, and corporate earnings begin to cycle down, we could experience a painful combination of a simultaneous contraction of both earnings and the P/E ratio. We have been looking for this for some time and eagerly anticipate the opportunity to acquire shares of quality companies at bargain prices in such an environment.*

**Impact on FAI portfolio design**... Because we believe the market is at the high end of its valuation cycle, we continue to maintain an unusually large allocation to our "**Stable**" asset categories, i.e. short and medium-term high grade fixed income securities, especially treasuries and money market funds. We expect these to more than maintain their buying power net of inflation in the short run, and to provide the cash for taking advantage of **Opportunistic** investments when they become available at lower valuations in the wake of the credit bubble adjustment. We also hold inverse funds which rise in value when the market falls.

### **Credit Constraints theme**

This theme could also be called "Too Much Debt Everywhere". Of our five themes, this is the one that's dominating the current headlines! And it relates well to Prof. Minsky's observations that complacency about risk inevitably leads to irresponsible borrowing for speculation in securities and other assets. And in the words of former Fed

Chairman Paul Volker, such eras "always end badly".

We have often cited the rising ratio of total debt in the US to annual GDP as one way of measuring our collective debt service burden; from an average of less than 150% prior to 1980, total debt has soared to a recent 340% of GDP! Borrowing to pay for consumption has been a steady tailwind for economic activity *for an entire generation*. If borrowing has reached a zenith, as is being signaled by a plethora of sub-prime mortgage defaults, a return to sane standards for lending may change that tailwind to a headwind that ***could slow or even slightly reverse US economic growth until debt ratios become more manageable***.

We think that the extent of the credit problems created during the careless phase of the debt cycle have not yet been fully exposed; we are especially concerned about off-balance sheet liabilities that banks are just beginning to reveal and about the hundred trillion (sic) dollars of financial derivatives in which leading banks have been prominent participants. **The possible consequences of increased credit constraints are very serious, so we believe a defensive portfolio posture is still appropriate.**

For an exhaustive amount of information and provocative prose concerning the extremes of domestic debt, visit the Grandfather Economic Reports at <http://mwhodges.home.att.net/nat-debt/debt-nat.htm>. Mr. Hodges graphs the acceleration of debt at the government, financial institution and household levels in modern times, and does a pretty good job of explaining the risks of a financial calamity as the natural consequence. He quotes one of our favorite theoreticians, **Ludwig Von Mises** of the Austrian school of economics...

*"There is no means of avoiding the final collapse of a boom brought about by credit (debt) expansion. The alternative is only whether the crisis should come sooner as the result of a voluntary abandonment of further credit (debt) expansion, or later as a final and total catastrophe of the currency system involved."*

The dramatic weakness of the US dollar the past year suggests that the currency markets are not waiting around to see whether lenders and borrowers will voluntarily start attending twelve step programs for debt dependency.

**Impact on FAI portfolio design**... we continue to hold significant positions in gold bullion in the expectation that central banks will enable politicians to continue their profligate ways by devaluing national currencies. We see evidence of an emerging round of competitive currency devaluation among nations, denied, of course, by all parties. In the last three months, money supply (money of zero maturity) has been expanding at an astounding 21% annual rate around the world, which we think must eventually undermine paper currencies. Gold is the only “currency” the supply of which is naturally constrained, hence unable to be manipulated by governments; so we consider gold bullion an attractive Opportunistic investment. In the “Stable” portion of our portfolios we eschew riskier credits because we expect the interest rate spread between treasuries and “junk bonds” to widen considerably; one day, perhaps soon, we hope to find opportunity in investment grade corporate bonds.

### **Energy Constraints theme**

Our original name for this theme was “Decline of oil production”. The name needs a little updating to emphasize the fact that global demand for energy (especially of the hydrocarbon type) is and has been plainly growing faster than world supply, causing prices to spurt irradically higher and higher. Oil prices have more than doubled since that time. In fact, though, world oil *production* has not actually declined in the last three years. Nevertheless there has been no improvement in the amount of spare productive capacity as demand continued to grow not only in the US but especially in the emerging economies of Asia. Today demand for oil is roughly 85 million barrels a day and stated productive capacity is only about 2 million barrels a day greater than that, leaving precious little room for interruptions to supply.

Is this tight market a temporary or lasting situation? That’s the critical question, and there are two parts to the answer... demand and supply. On the demand issue, world oil consumption is growing approximately 1.5% a year (demand growth of 1.25 million barrels per day annually.) The markets have been surprised that the 3-year doubling of price seems to have inspired virtually no efforts toward conservation, at least in the US. When prices rose sharply in the early 1970s, US consumption declined by about 25%, then gradually increased to its previous levels over time as the economy and population grew larger. This time, though, no meaningful cutbacks are apparent.

But the big growth in demand, not surprisingly, has been from China, India and their trading partners, and from OPEC countries where oil prosperity is now producing dramatic economic growth in places like Saudi Arabia and Dubai. Demand growth from the newer economic powers seems a more or less permanent reality and it explains the increased political dimension in the acquisition of oil companies and properties.

If world demand continues to grow, can supply keep up? OPEC excess productive capacity (which for all practical purposes means Saudi Arabia’s excess capacity) is a wild card. Some believe Saudi has already peaked, others think they’ll add 2-4 MBPD in the next couple years, which could reduce the price pressure IF they choose to make the capacity available. And that is a big IF since \$98 oil is obviously a pleasurable situation for the Saudis and their Mideast compatriots, not to mention Nigeria and Venezuela.

We keep abreast of all the expert opinions on the complex supply/demand equation including the dramatic declines in some of the biggest fields, new technologies that could enhance the production of older fields, non-traditional sources of oil and gas such as biofuels, solar and wind, coal conversion and Canadian oil sands. We watch the growing trend toward nationalization of oil properties and the scramble by China, India and Russia to control long-term hydrocarbon supplies.

*Our working assumption is that long-term world energy consumption growth is virtually unstoppable, that supply gains from non-conventional sources will not be dramatic and will surely be expensive, and that political risks to free market supplies will persist.*

**Impact on FAI portfolio design**... It is our current expectation that global oil and gas supply will remain tight for the foreseeable future and that the best investment strategy is to own oil and gas reserves in the most politically safe areas of the world, especially North America. For that reason our portfolios feature Apache Corp. (APA), an exploration and production company that has consistently grown its production and its reserves, Exxon Mobil (XOM), the largest integrated oil company in the world with a powerful balance sheet, and several Canadian Royalty Trusts, Advantage Energy Income Fund (AAV) and Enerplus (ERF) which feature double-digit dividend yields and substantial US and Canadian reserves. Altogether, oil and gas account for about 20% of our Opportunistic investments.

We'll save the review of the last two FAI Themes (Emerging Nations and Aging Populations) for the next issue of the Blue Sheets and spend the rest of this one in reviewing some of the individual stocks we have bought and sold the past few months.

### **Review of individual securities activity**

Financial Advantage clients will have noticed a little more activity than usual in the individual stocks in their portfolios, so we thought you would be interested in an update to our thinking on these investments.

**Apache (APA)** is a large holding for most clients, typically in the range of 5% to 6% of assets depending on each client's risk preference and custom allocation needs. Reserves are in largely safe areas of the world (US, Canada, Gulf of Mexico, North Sea, Egypt, Australia and Argentina). Both production and reserves have

grown steadily the last 20 years. Balance sheet and cash flow very strong.

At the end of October, on the wings of a 40% three-month gain we took some profits in APA at about \$101 ½ a share and trimmed portfolio positions back to their original percentage allocation. We believe that routine re-balancing of this sort is one of the keys to long-term investment success; a way to "make volatility your friend".

**Dresser-Rand (DRC)** is the dominant maker of complex rotating equipment (such as turbines and compressors) for gas pipelines, drilling rigs, production platforms, refineries, and just about every part of the energy food chain. Sales volume and profit margins are growing, and a large backlog of well-priced work provides earnings visibility. We had an average cost of about 24 and a price target of 34. When the stock hit our target we still liked the story as a long-term investment but a 2% position had grown to a 3% position, so we took our profits by reducing back to 2%.

The stock continued to rise and we sold another 1% (i.e. half our remaining position) at 40! Because the fundamental story has long-term visibility we have been reluctant to sell it all. In the future we will either sell what remains at a handsome gain or, if the market softens or there is a short-term disappointment in the earnings progress that we think is temporary, we may take advantage of any price weakness to build back to a 2% position. We think it is important for us to remain "value investors" even when the market gets enthusiastic about one of our stories.

**American Commercial Lines (ACLI)** pushes barges up and down the Mississippi River and its many tributaries and man-made extensions. We established about a 2% position over the course of several months with a cost of about \$23 a share, and eventually sold it for a little more than \$14, all in the same year. The simplistic story was that barge transportation of liquid and other bulk commodities would be gaining market share vs railroads because of a) an enormous cost-per-ton-mile advantage due mainly to fuel efficiency and b) because rail capacity had become somewhat capacity

constrained and many long-term contracts were up for renewal. Two consecutive quarters of earnings disappointments cast at least some doubt on the ability of the management team to achieve the objectives, but more serious for us is the fact that they leveraged up the balance sheet to buy back shares in the low 20s, adding risk to the earnings story and diminishing the takeover potential. Sometimes you need to part company with a stock if you lose confidence in the story; this was one such.

**Tata Motors (TTM)** is the largest vehicle manufacturer in India, even bigger in small commercial vehicles than passenger cars. These shares trade on the New York Stock Exchange in dollars. This past June we bought our initial position in TTM at about 16 ½ as a way to participate in the continued above average growth of the Indian economy, the planned construction of a highway system to connect major cities, and the probable expansion of the number of Indians who can afford motorized transportation. Tata is a highly regarded family in Indian commerce, the company sports a good track record and a strong balance sheet and the stock sells at 10 times estimated earnings. Adding some excitement, they expect to introduce a four wheel car in the \$3,000 price range next year! This stock fits our value criteria and our Emerging nations theme.

**CapLease (LSE)** owns and lends against commercial buildings (mostly first class office buildings) occupied by investment grade tenants under long-term triple net leases. It is a very specialized kind of financial company. The US government is its largest tenant. One recent transaction includes the Tiffany headquarters in suburban NJ, the University of Connecticut Health Center and three large Allstate Insurance locations. We think LSE's portfolio risk is very low and that the stock has been sold down in sympathy with the ongoing credit crunch. The REIT structure provides a current yield of nearly 10%. Yesterday we increased our allocation to CapLease, buying the shares below book value.

**MoSys Inc. (MOSY)** owns and licenses intellectual property to makers and designers of specialized semiconductor chips. Their designs allow portable devices (e.g. games and phones) to operate with significantly lower power consumption and to be built less expensively than with older competing technologies. The best selling current user is Nintendo's highly popular Wii game. Last week the President was replaced by one of the original founders, Len Perham, who received 1.2 million options, so he has plenty of financial incentive to get this company rolling. He is extremely well connected in the semiconductor field and has several important company successes behind him. We hope Perham is the catalyst to bring this company's technology to prominence. There is no long-term debt, cash flow is positive and MOSY has about \$2.80 a share in cash. To buy this company out at a fat premium to the current price would require only pocket change from some of the likely buyers. This stock must be called "speculative" since it is not earning an after-tax profit yet. We doubled our overall position in MOSY on the announcement of Mr. Perham's commitment.

**Canadian Royalty Trusts (AAV and ERF)** don't seem to have a friend in the world; that always gets the interest of a value investor. These owners and operators of oil and gas producing properties in western Canada and the US sport very high dividend yields that we believe will provide some sort of floor under the share price, 16% in the case of Advantage Energy Income Fund (AAV) and 12% for Enerplus Resources Fund (ERF). The cash flows more than cover the dividend and the rest is used to replace reserves through acquisitions and low-risk drilling. A year ago the Canadian government decided to do away with the REIT-like tax feature and to tax these companies' earnings in a normal fashion so that distributions are expected to be reduced after 2010. We think the prospective loss of the tax advantage is more than reflected in the current price and that if oil remains as expensive as it is today, there will be bidders for the producing properties and we'll be glad to own them. (One Royalty Trust is being acquired by the Abu Dhabi national oil company.)

It is nice to have some of our assets valued in Canadian dollars as a diversification to the US buck. And we are very happy to own oil and gas in the ground for a total investment (enterprise value... that is total corporate debt plus the market value of all the stock) of \$15 to \$16 as barrel of oil (or equivalent in natural gas).

*For the Investment Committee:*  
J. Michael Martin, J.D., CFP  
November 28, 2007

**DJIA 13,180**

**S&P 500 1,453**

**NASDAQ 2,637**

**30-yr Treasury 4.37%**

**NOTE: Being careful has been a profitable strategy.**

Since the start of this calendar year the lowly treasury bill has produced a higher return than the S&P 500 stock market index! As a matter of fact, *for the last nine years T-Bills have beaten the return of the overall stock market!* FAI model portfolios have done *considerably* better than T-bills and the stock market in both time frames despite our very conservative portfolio construction.