



FINANCIAL ADVANTAGE, Inc.®

*for a better life®*

## The *Blue Sheets*®

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

*November, 2008*

# *Everyone Loves a Sale... Right?*

## **50% off! Why aren't we happy?**

*Quite a few clients called us after reading their October account statements to ask, "Should I be scared, or does Financial Advantage have this under control?" A 50% nosedive in the S&P 500 index of large company stock prices is bound to unnerve any investor who is paying attention! This bear market has been even more punishing than the now-famous "bursting of the tech bubble" between January 2000 and October 2002, but it has happened in just one year! It's more than a little disquieting; what's going on?*



Some of the most brilliant money managers on the planet, with exceptional long-term records, have experienced devastating results this year... Berkshire Hathaway's Warren Buffett (-41%), Marty Whitman of Third Avenue Value (-53%), and Bill Miller at Legg Mason Value Trust (-63%) to name a few. While FAI's portfolio shrinkage has been much more moderate (-18% for our average portfolio), it's still a *decline*, something Financial Advantage clients are not used to. So, we want to devote this issue of The Blue Sheets to reviewing our overall perspective on the current realities in the economy and the securities markets... how we've been managing risk so far, what's ahead for the economy and how we plan to get back to positive returns in spite of the turbulence.

Perhaps the best way to discuss the outlook is by responding to a number of specific questions we're being asked by clients as well as by financial reporters who've been calling us almost daily in their search for practical insights on how to deal with a sudden *halving* of world stock prices.

**Query:** *They say this is the largest one-year decline in stock prices since the 1930s. Is there a simple explanation for this extraordinary turmoil?*

**FAI observation:** A free market economy of 300 million souls, interacting with 6 billion other residents of the planet, is indescribably complex. Nevertheless, we do think there is one clearly identifiable issue at the core of the current troubles... it is the rather sudden about-face from a long era of profligacy and easy credit in the developed world to one which is likely to be characterized by frugality and thrift. The implications are significant and markets are trying to adjust to the uncertainties.

Regular readers are familiar with our chart showing the growth of US debt from 125% of GDP in the early Reagan era to 350% of GDP recently. (Translation: debt has grown *twice as fast as the economy* for more than 25years!) When debt reached 300% of GDP about 3 or 4 years ago, we got concerned about the inevitable demise of this exceptional credit boom; our concern was appropriate but premature since a surge in home prices encouraged and extended the nation's borrowing frenzy, and the stock market rose along with it!

Wall Street alchemists packaged and sold to institutional investors around the world US mortgages and other loans that should never have been made, "secured" by properties that were vastly overvalued. And when the inevitable defaults began to appear, hedge funds and others that had invested in these loan packages with tons of *borrowed money* began to unravel at the speed of light. And the peaking of a generation-long credit boom came center stage.

Lending institutions, both banks and non-bank lenders, now find their ability to provide credit deeply impaired as they write down their chimerical loan portfolios; they have become extremely selective in making new loans with sobering consequences for consumer and business loan activity. The felicitous credit cycle has officially reversed course, and it may well take years of stringency before the debt burden stabilizes at a more manageable level. In the meantime, what had been a tailwind of economic stimulus for a generation is becoming a suppressant of equal and opposite force.

We think (and securities markets seem to be moving toward a similar expectation) that this wrenching reversal from credit abundance to penury is a profound turn of events; the paying down and writing off of debts, and the renewed awareness of the need to save will probably slow global economic growth to a crawl for a few years or even longer. In a no- or slow-growth economy, the profitability of businesses generally will recede from recent peak margins. Such an uninspiring environment will gradually sap the optimism from investor expectations, shrinking P/E ratios (the emotional barometer of investor expectations). A minority of companies will prosper; more will flounder. No more free rides on the broad index funds.

**Query:** *Sounds like it's going to be rough for a while. Can an investor expect to make any money in such an environment? Might it be better to buy bank CDs and "hide out" for a few years?*

**FAI observation:** The economic environment will almost surely get rougher; yes, that is what we're saying. Nevertheless, FAI is confident that creatively managed portfolios will be able to earn a return significantly higher than CDs and higher than the rate of inflation. Maybe not next month, or next quarter, for we cannot know whether valuations will get as low as they did in 1974 and 1981; the market may have already bottomed or it could conceivably go lower. Whatever stocks do in the short run, a great deal of corporate earnings distress has already been

discounted in their prices. And if they go lower the upside opportunity becomes even greater for those who have cash and the courage to take advantage of it.

One thing we are quite confident of is that a successful portfolio in the new environment will be very different from one that worked during the credit boom years. This time it is *not* a case of “just be patient and hold on; things will get better as they always do.” No! Things will be different; very different. Without the support of a global credit boom, there will be no “rising tide that lifts all the barges.” The competitive environment will be much tougher for all kinds of business and the market will sort out the well-managed and financially fit from the lucky and the leveraged.

*Capital markets are rapidly adjusting to this new economic reality as attested by the 50% drop in stock prices and record interest rate spreads between Treasuries and corporate bonds! On the other side of this adjustment lies a time of great opportunity... to take advantage of it will require an understanding of changes in consumer behavior, government policy, the uses of debt and the interaction of sovereign nations. And it will require imagination and innovation in portfolio design. It's going to take work! (Thomas Edison once said, "Opportunity is missed by most people because it is dressed in overalls and looks like work!")*

So, the main reason that it would be a mistake for most investors to liquidate now is the loss of great opportunity. Remember, prices of the stocks of some world-class businesses are very much on sale right now.... often for reasons having nothing to do with their future business prospects. Even if panic selling and selling that's dictated by margin calls and redemptions take stocks briefly lower, the stocks of great companies will not remain depressed; they are too valuable to remain mis-priced. In the not-too-distant future we will look back on high dividend yields and single-digit P/E ratios and wonder

how we could have missed the opportunity of a lifetime!

A second compelling reason to stay invested is the likelihood, for most retirees, that CD interest rates will not allow them to fund a comfortable retirement for the rest of their lives. Because CD rates average little more than the inflation rate, CD-seniors face a good chance of running out of money and moving in with the kids. Example: a 60-year old has \$2 million and only needs to withdraw 4% (\$80,000) a year for living expenses and taxes. Suppose he invested in CDs averaging 3.5% interest, and inflation is 3%. On these numbers he'd likely be out of cash before he's out of breath. That is exactly the problem we are devoted to preventing. We are convinced that active investing in stocks and bonds is still the odds-on best way to achieve retirement goals.

**Query:** *Since FAI actually did anticipate the end of the credit boom and also wrote frequently about over-valuation and the coming P/E contraction, why did you stay in the market at all? Couldn't these losses have been avoided?*

**FAI observation:** This is a very forthright question and we'll try to answer it just as forthrightly. If our concerns had led us to an all-cash portfolio in January we would look brilliant today. But we would not have really *been* brilliant; we would have been *lucky*, because none of us knew then what we know now. We never want our investment results to depend on lady luck, and that's what you do when you make extreme bets. Nor do our clients want the quality of their retirements to depend on a roll of the dice. We have often said that we could build a portfolio that would do very well in the Great Depression...but in any other environment it would be awful!

Investing is all about valuing future cash flows; that is, putting an appropriate price today on cash flows from businesses or bonds that may or may not actually be available in the future. Hence, investing brings us face to face with the limits of our knowledge about the future.

The responsibility which most clients have assigned to us is to manage the investment of their life savings in such a way that their portfolios will provide enough cash flow to support their lifestyle during many years of retirement. While there are short-term aspects to our duties, such as maintaining appropriate liquidity and minimizing taxes, successful investing is essentially a long-term enterprise. We make judgments about risks and opportunities in the context of what hundreds of years of this human activity have taught us about *what is possible*. Since neither risks nor possibilities will be clear until some future date, investing is necessarily more an art form than a branch of science. As much as we may want it to be reducible to formulae, investing will always require judgment and the ability to adapt to change.

It is one thing to realize that stocks are expensive or cheap, or to identify a major future change in economic forces like the credit cycle; it is quite another to get the timing right! Decades of study and experimentation have taught us that it is foolish to predict how far cycles might go before reversing, whether the cycle involves credit availability, interest rates, inflation, profit margins, consumer confidence, the regulatory climate, or any of the myriad variables that ultimately converge in securities prices. Yet, since these all influence future cash flows, investors need some way to weigh their influences.

During our long investment careers we've learned that securities markets are capricious and completely unpredictable in the short run. Stock and bond prices are far more volatile than the economy as a whole or the fortunes of individual businesses. Life has taught us that hubris with respect to our ability to anticipate the behavior of markets is foolish and inconsistent with our serious responsibility. Humility in the face of perpetual uncertainty is always appropriate.

However, having acknowledged the limitations of forecasting, we remain quite convinced that the capriciousness of markets is manageable; as a

matter of fact, we like to describe our investment work as "managing perpetual uncertainty." Our approach is to keep in mind the historic range of valuations that markets have assigned to all sorts of investments, and make every effort to reduce our exposure to valuation risks at the extremes, and to lean into extraordinary value opportunities when fear or ignorance make them available... always with an eye to genuine diversification.

*Rather than making big, abrupt decisions like retreating to cash to stop the pain of a declining market, we've learned that it is wiser, more realistic, and more profitable in the long run to keep tilting our portfolios in the direction of our strongest convictions, and to make major shifts gradually.*

**Query:** *While stock indexes were falling by 50%, just what has Financial Advantage done differently to limit the damage in its clients' portfolios? How have you "tilted in the direction of your convictions"?*

**FAI observation:** As you know, we have been writing about credit risks and gradually reducing our portfolio exposure to credit and equity risks for several years. We have made six main adjustments to our portfolios to limit investment risks...

- a) Reduced our total stock market exposure and became very selective about which stocks and which sectors we wanted to own.
- b) Created a proprietary method of diversifying our portfolios because we realized the traditional "style box" groupings were moving in lock-step.
- c) Held unusually large allocations to cash (mostly Treasury Money Market Funds) and short-term high-quality debt
- d) Built a significant position in gold bullion over the last few years
- e) Built substantial positions in inverse funds (that rise when the market falls)

- f) “Made volatility our friend” via our re-balancing discipline... taking profits when stock prices soared and buying more when favored securities were unfairly pummeled

**Query:** *Do you think we are closer to a bottom than to the top? Please say yes!*

**FAI observation:** Yes! The S&P 500 topped in October, 2007 around 1550 and closed this November 20 at 752; that’s a brutal 51% tumble. Since 752 is more than half the distance between 1550 and 0, it is closer to the bottom! But the stock market slide may have further to go. For example (and this is just big-picture boundary thinking, not a forecast by any means) if S&P earnings should drop 50% from their high (not at all out of the question) and if the Price/Earnings multiple should drop to 7 (it has fallen that far in a few other bear markets) theoretically that could put the index down as low as 300. The global economy has some very big adjustments ahead of it... workforce reductions, elimination of excess capacity and figuring out a way to pay off debts; we’re not sure the market has discounted all the future stress. So we think a degree of caution is still in order despite the big decline in stock prices to date... which is why our current net long exposure to stocks is only about 10%!

And yet, some stocks that we follow closely have become irrationally cheap because of forced sales by mutual funds and hedge funds that must raise cash for redemptions and by retail margin calls as well as plain old let-me-outa-here fear-based selling. We should also mention that even in long secular bear markets like the one we’ve been in for 9 years, there tend to be really big upswings, so we expect some of that. We believe volatility will be a market characteristic for some time, and we have developed portfolio strategies to benefit from big price swings.

**Query:** *Like what? How do you profit from market swings without becoming a market timer? How do you, in your words, “Make volatility your friend”?*

**FAI observation:** Here are a few of our strategies for coping during a bear market.

- Dramatic stock market rallies inevitably occur even during long bear markets of the kind we have been experiencing. We’ll take profits (reduce our stock market exposure) during such rallies, until we discern that the credit crisis has resolved itself and we’re back into a more normal valuation range.
- We own both short and long positions to provide profit opportunities no matter which way the volatility is expressing itself! When we take gains in an inverse index (the ones that rise when the market falls) we expect to re-invest those gains in stocks which will have gotten cheaper (since the shorts and longs are opposed, a rise in one should correspond to a fall in the other). This will make your trading activity a little more brisk than before, until things calm down.
- We have been putting greater emphasis on interest and dividend income from diversified sources; our portfolios’ cash income is approximately 5% today, which is better than CDs and greater than current inflation. There will be some dividend cuts along the way; we actually expect it as companies adapt their payouts to short-term business pressures. In some cases we think the cuts will be less than the market expects and the reduced dividend will be greeted with a stock price increase!
- The bond market seems to have been oversold more than equities, so we are about to increase credit and duration risk in the “Opportunistic” part of our portfolios.
- We have just begun to accumulate stocks of great businesses...typically these are companies with a global presence, a history of high returns on capital

employed, a strong balance sheet, and a competitive advantage such as technology or highly regarded brands.

- We are examining the possibility of executing “paired trades” such as shorting the 10-year treasury (which has a below-inflation-rate current yield) and going long investment grade corporate bonds in order to profit from the inevitable narrowing of the interest rate spread between the two... without having to predict just how it will narrow!

**Query: OK, what about the government?  
There’s a new, expensive program to bail out some sector or another every couple days!  
What’s your take on the dramatic increase in government spending and involvement in the private sector?**

**FAI:** The increase in government involvement is our greatest long-term concern as investors. It is still early in the game, so we choose to be optimistic for the time being that interventions will be temporary and that markets will have the opportunity to sort out private sector foolishness and clear the decks for a new business cycle. The risk that government intrusion will expand further and that huge Federal deficits will become commonplace is the main reason we still have significant short positions in our portfolios even after a 50% decline in stock prices.

We watch heated debates on early morning financial shows about whether Congress ought to fire the management at Ford if they do so at GM! And we ask ourselves, “Does it bother anyone that we are having these discussions?” If an elected government is properly expected to provide some regulation of powerful business interests, does it make sense for the regulator to become an owner of those businesses? Are lawmakers any less vulnerable to foolishness and avarice than business folk?

One of our greatest concerns regarding the control of business interests by government is its

inability to adapt efficiently, if at all, to the plethora of mistakes and unintended consequences that will inevitably attend their decisions. By nature, government is insensitive to traditional market signals, the communication system between business and its customers; the arbiter that allocates capital to its highest and best use.

Representatives of 50 states’ interests, running for re-election every few years, and having little-to-no experience or training in business and finance, can hardly be expected to make sound and independent judgments regarding the prosperity of those businesses and the suitability of its products and services, can they? When Ford Motor Company realized what a market disaster the Edsel was back in the 1960s, it quickly dispatched the iconic failure to the auto museum and moved on to introduce the wildly successful Mustang! What do we suppose a sitting Congress would have done in such a situation? Well, they are debating the fate of that entire industry right now, so perhaps we’ll have a chance to see!

The rapid intrusion of government into financial affairs is also the main reason we have a large gold bullion position. Heading into this recession, not only the US but Euroland and the UK as well already had unmanageable commitments to provide socialized benefits to their electorates (pensions and medical, educational and unemployment benefits) before they started back-stopping their publicly-owned banks and insurance companies with loans, guarantees and even direct investments. Now they are promising literally trillions of dollars (or the Sterling and Euro equivalents) to prevent the prospective failure of the largest insurance companies, commercial banks and investment banks. Naturally this largess toward some has created a line around the block of other would be bailees.

This past summer, while the Dow Jones Average was considerably higher than it is now, Washington handed out a few hundred billions of “stimulus” checks to help the weary

consumer. Early reports on the holiday shopping activity suggest the weariness continues, prompting serious discussions on Capitol Hill of just how large the next stimulus should be... not, we note, about whether such activity is wise in the long run. And of course, we all fear the loss of auto jobs if lawmakers and regulators don't help GM and Ford. Where does it end? Something very fundamental to keep in mind, especially on days when the markets breathe a bullish sigh of relief over each rescue plan and each stimulus package, is that governments, per se, do not have any money! They are giving away what they do not have, and there are essentially three ways for them to get it. A) They can sell bonds, i.e. borrow the money from private investors. B) They can raise taxes and C) They can print the money. Let's look at these very briefly.

A) Borrow the money from citizens and foreigners. Certainly bonds will be sold. And why not? Three-month government paper is fetching an extraordinary 0% interest rate! Some people who do have money are begging the government to hold their cash and require nothing more than a promise to give it back! This too shall pass! Thirty-year US bonds pay a wimpy 3.7%, down from 4.7% just a few months ago, oblivious to the exploding risk of monetary inflation (see C, below). Huge waves of government borrowing would crowd out corporate borrowers, raising the cost of capital to businesses and dampening economic activity.

B) Take the money from citizens. Raising taxes has only limited promise as a source of government funds. There have been several credible studies in recent years concluding that, no matter where the marginal income tax rate is set, the most tax revenue the federal government can squeeze out of GDP is 20% of it; we've been at that level for quite some time. Some say that is because businesses and individual taxpayers find ways of avoiding their obligations when tax rates rise. Others think that high marginal tax rates discourage investment and entrepreneurial risk taking, which dampens the pace of the economy and shrinks the taxable income base. Whichever

a person's point of view, it seems that raising tax rates doesn't expand the treasury. So where will the money come from? There is one remaining source...can anyone spell Zimbabwe? Or Weimar Republic? (See the last issue of our Blue Sheets.)

C) Print the money. Fabricate it! None of the central banks in developed countries any longer has a currency backed by anything but trust; trust that policy makers will maintain the buying power of their currencies. The gold standard, which required government issuers of paper currency to purchase gold in proportion to the expansion of its currency outstanding, was effectively abolished in 1972. (News flash: the US dollar has lost 66% of its buying power under this arrangement, even without any crises as dramatic as the one now being papered over.) So now they can produce money in unlimited quantities. *And they will.* We may well have deflation in the short run, since an economic contraction is a deflationary force. But in time, we believe that a pronounced increase in inflation is all but inevitable, and our investment strategies will reflect this expectation.

Our job is not to develop government policy; our job is to find ways to make clients' nest eggs as productive as possible in whatever policy milieu is extant. Inflation will be extant! For thousands of years gold has been accepted as a store of value and medium of exchange... a currency. Government cannot increase gold's supply at will as they can with fiat currencies. Gold will have a prominent role in our portfolios as a defense against what we believe is the inevitable devaluation of government-sponsored currencies; as a protection for the buying power of our clients' savings.

**Query: *I am grateful that my portfolio shrinkage has been relatively modest, but, hey, a year ago I had 2 million dollars that I worked a lifetime to save, and I have LOST \$360,000 in less than 12 months! It is hard to feel good about that! It makes me feel like getting out of***

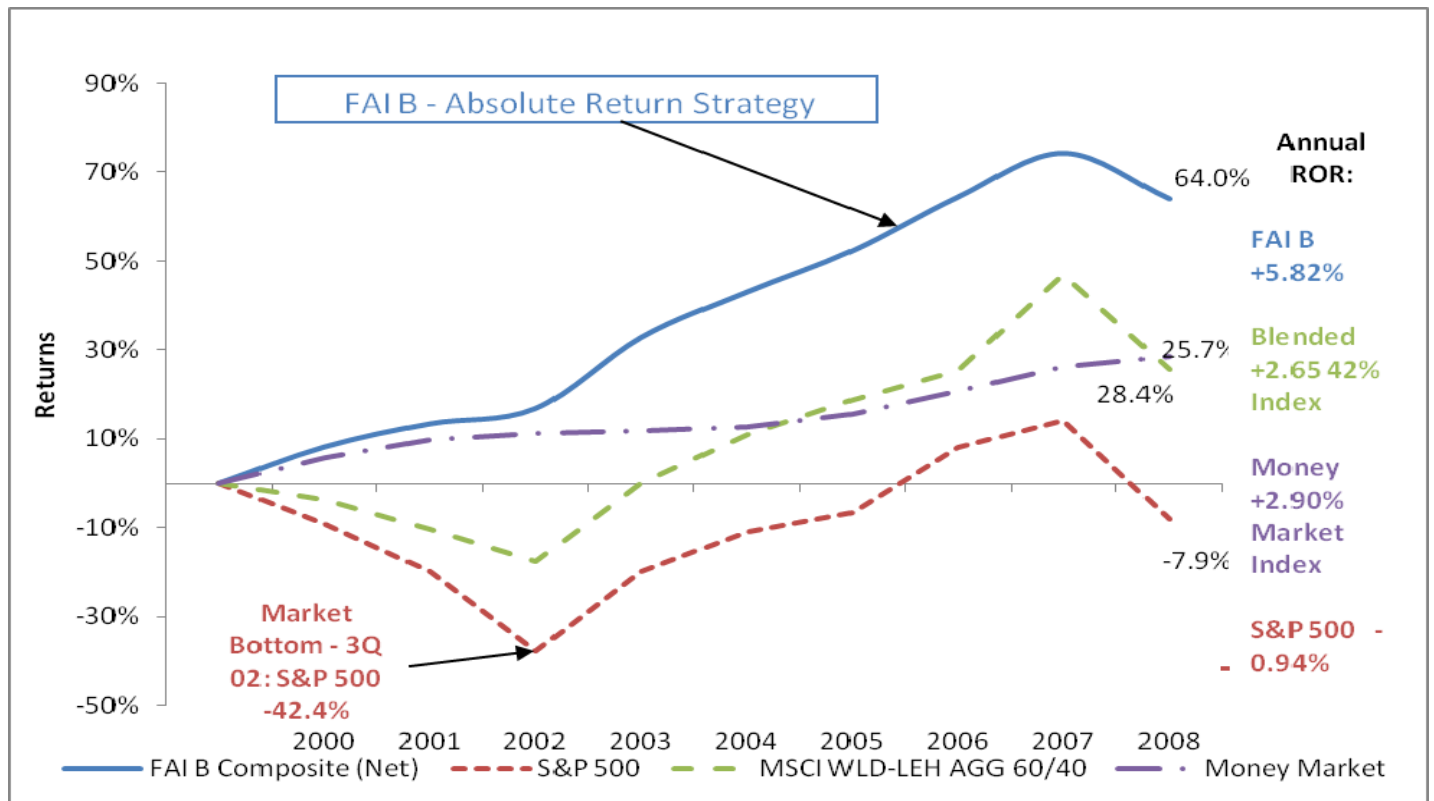
*the markets to stop the bleeding. What do you think?*

**FAI observation:** We certainly don't feel good about shrinking portfolio values, either; who could? We take our responsibility as advisors very seriously and we invest our personal money right alongside our clients', so we know the feeling! But we are confident in our understanding of what's going on as companies, governments and individuals try to adapt to this wrenching change from giddy consumerism to something more sober and more durable.

It is precisely *because* change of this magnitude creates so much anxiety and irrational behavior that *all sorts of investment opportunities eventually present themselves*. A big part of our assignment as professionals is to keep perspective, manage the short-term damage and retain enough courage, optimism and cash to take advantage of extraordinary opportunities

that are being created with each decline in the market indexes.

Since the dawn of this millennium (1/1/2000) stocks have been nobody's friend! While keeping everybody up at night, the S&P 500 has returned less than zero in almost 9 years! Yet FAI's research-based, gradualist approach to investing has earned an average of 5.8% a year in the same time frame (see the chart below) with absolutely no help from the market. It's not goosebump territory, but it is solidly ahead of cash and inflation even after this year's contraction!



**January 1, 2000 through September 30, 2008**

Unless you give in to fear and bail out of securities altogether, you need not consider declining market prices for your stocks as a permanent “loss”. We know that markets are volatile and capricious. The market value of a company’s stock may be lower than 6 months ago, but if the long-term ability of that company to earn profits is not impaired, or if your bond is making interest payments on time and has a senior position in the capital structure, we think it makes sense to ignore the price fluctuation as so much short-term noise. A very loud noise that gets your attention, but noise nonetheless.

Finally, since stocks of many good companies are 50% cheaper than they were a year ago, and since more than 80% of our portfolio value is untouched by the storm, and since we are very “underweighted” in stocks, we are face to face with a great opportunity to begin slowly and purposefully moving money into sound bonds and stocks of great businesses that are being offered at fire sale prices! A typical B Model portfolio at FAI is currently only about 10% net long stocks (on purpose) so there is plenty of room for us to do just that.

**Query:** *This is all very interesting, but I just want to know, “Am I going to be all right? Should I be figuring out how to reduce my spending?”*

**FAI observation:** Sorry to go on so much and to get so philosophical! Yes, you’re going to be all right. Of course that is the real issue, isn’t it? Which is exactly why the team at FAI is constantly working to develop a very different approach to making your nest egg productive for you in the very new kind of economic world that is emerging for all of us.

Whether it is time to take a critical look at living expenses is an important question, too. And a very personal one. The good thing about reviewing your living expenses it is that it’s a part of the success formula over which you have some control; you can actually make your savings last longer and increase your comfort level if you take smaller withdrawals. But the whole point about retirement investing is to maintain your preferred living standard, so don’t make withdrawal decisions willy-nilly. You’ll want to review spending and withdrawal levels with your FAI Advisor. We are blessed that the very talented Dennis Stuckstorf, CFP® joined us as Senior Financial Planner this summer, so we’re in a great position to help you think it through. Just give us a call.

*For the Investment Committee:*  
J. Michael Martin, J.D., CFP  
November 22, 2008

**DJIA** 8,046    **S&P 500** 800    **NASDAQ** 1,384    **30-yr Treasury** 3.68%



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