



FINANCIAL ADVANTAGE, Inc.®

for a better life®

The *Blue Sheets*®

Our quarterly commentary on the global economy and securities markets

September, 2009



Managing Perpetual Uncertainty

Our process for preserving your capital in a volatile world

In the last issue of The Blue Sheets® we examined some of the profound ways in which the world is changing, and the new opportunities and new kinds of risk that may proceed from those changes. In this issue we take a look inside the Financial Advantage process for investing our clients' irreplaceable life savings during what is likely to be a volatile period of transition to an unfamiliar future.

Risk is serious... and strange

Risk is a funny thing; not funny ha-ha, but funny strange. Very smart people find themselves unable to agree on a definition of investment risk, but it's some sort of unpleasant thing that may or may not occur in the future. Because it concerns something that might not even happen, risk is hard to measure ahead of time and impossible to predict. And yet, deciding the appropriate *amount* of risk and the *kinds* of risk to take are critical in planning how best to invest money for a family whose dreams may hang in the balance.

Risks are not just theoretical; unexpected bad things *do* happen, and they often happen without warning! Watching the US stock market lose

about half its value in just 6 months was a recent reminder to all investors of the *real* possibility of *serious* losses. And yet, isn't it interesting how the latest six months of *rising* stock prices has caused many to forget the abject panic they felt in the vortex of last winter.

Academics tend to equate investment *risk* with price *volatility*; the implication is that time will always restore the value of a well-diversified portfolio of stocks because market downturns are always temporary. There is widespread belief that economic growth, with brief cyclical interruptions, is a permanent feature of the modern world. This was the prevailing orthodoxy during the '80s and '90s when every market decline was succeeded by a new high. But its faith in growth sounds a lot like *Irving Fisher's famous declaration in the late 1920's that America had entered into "permanent prosperity."*

Today, even though the Dow Jones Industrial Average sits below its level of 10 years ago, this

unwavering confidence in "stocks for the long run" remains the dominant belief system. It's a perfect example of Peter Bernstein's observation that the investor consensus has a bias toward the past. This helps explain how easily the investor class has embraced the current assertions of Wall Street and Washington that growth is back. Never mind that the GDP growth of recent years was dependent on an unsustainable credit boom that now lies in shambles.

Over the last 10 years it took \$6 of new debt to generate \$1 of new GDP. Clearly unsustainable!

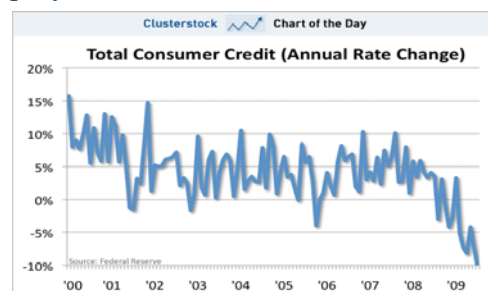
Diminishing Returns from Debt-Financing by Decade			
Date Range	Decade Change in Debt (\$, billions)	Decade Change in GDP (\$, billions)	Debt/GDP
12/31/49 – 12/31/59	337.6	248.0	1.36
12/31/59 – 12/31/69	752.1	491.3	1.53
12/31/69 – 12/31/79	2,785.2	1,654.9	1.68
12/31/79 – 12/31/89	8,563.7	2,922.3	2.93
12/31/89 – 12/31/99	12,562.6	4,026.0	3.12
12/31/99 – 03/31/09	27,501.2	4,570.3	6.02

Last year, modern acolytes of permanent prosperity were rattled by unfamiliar rumblings as the tectonic plates shifted

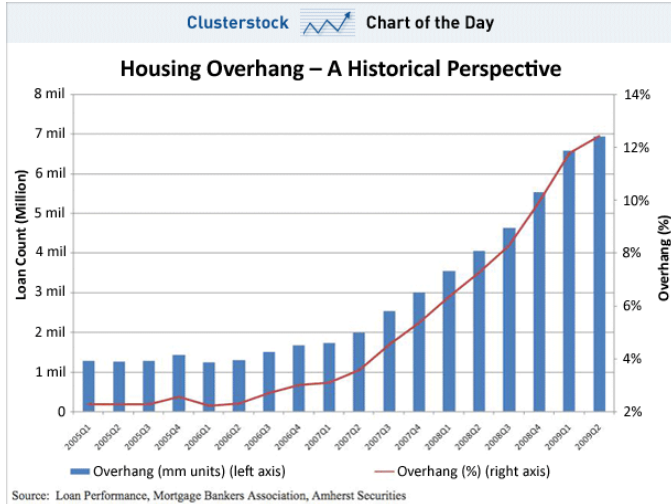
beneath the world's highly-leveraged capital infrastructure. True, there was observable damage on Wall Street, but enormous government rescue programs and a few convenient accounting changes seem to have cleared the rubble and restored calm among the citizens. The stock market breathed a giant sigh of relief, recovering half its losses in the last 6 months. Believers are streaming back to the temple, wondering why they ever doubted.

But for some of us a palpable uneasiness lingers.

Retail sales suggest shoppers are filling their carts more carefully, and the travelling class has been staying closer to home. Surveys indicate that lenders are clutching their capital more tightly, reducing credit card limits and restricting access to home equity loans.



Seven million homes are in the delinquency pipeline. And gold, the bomb shelter of the wary, remains in high demand.



Were last year’s rumblings a one-off? A random event to be followed by a restoration of the bucolic landscape we all knew and loved? Or might they have been nature’s warning of financial sinkholes opening up in the road ahead? Or perhaps we just had a rougher-than-usual recession from which we are already recovering? How will all this eventually go down in the history books? An FAI teammate says the market recent disconnect from the crumbling economic fundamentals remind him of the climactic refrain of the Grateful Dead’s ‘70s song, *Truckin’*. The lyrics use the band’s misfortunes on the road as a metaphor for getting through the constant changes of life:

Sometimes the light’s all shining on me
 Other times I can barely see
 Lately it occurs to me
What a long, strange trip it’s been!

The future, of course, is always unclear; perpetual uncertainty is, by turns, the seedbed of investment risk and investment opportunity. At FAI we have a mantra which keeps us aware that our work is always about managing uncertainty: “*Every day we wake up on the edge of tomorrow, and every day the horizon is shrouded in fog.*” Squinting hard to peer into the mist, we do our best to interpret the sounds and discern the shadowy shapes, but we can never see quite as clearly as we’d like; it is just not given to mortals to know the future! Being honest about this genetic constraint has saved us from many traps

of overconfidence. We have learned that to translate the continual flow of hard data into successful investment decisions, we have to rely on our reading of history, our experience of financial dynamics and human nature, our instincts and even our imagination.

At Financial Advantage in 2009, as we peer into that perpetual fog of uncertainty, we have become more guarded in our investment outlook *because* we are convinced that **the global economic environment is undergoing a fundamental transformation** (more on this below). This cautious view is shared by such prominent investment thinkers as Bill Gross, Mohamed El Erian, John Hussman, David Rosenberg and John Mauldin to name a few glitterati. We and they think the buy-and-hold style that was so successful in the ‘80s and ‘90s era of easy credit and steady economic expansion is likely to be ineffective and even dangerous, especially for retirees, during what may be a prolonged and volatile period of transition to an undefined future.

Profound change favors neither the naïve nor the faint of heart. If we are correct in our perception that western economies have been launched into a new era of credit constraint that will persist despite government’s best efforts to thwart it, it is likely to be a rather long winter. Slow growth, stubborn unemployment, debt defaults and costlier credit will be our norm until excesses are washed out and stability is restored. And *because* a credit-constrained environment is so unfamiliar, we think this emerging era of financial propriety presents *a wonderful opportunity for investors with the insight and courage to recognize and adapt to the changes.*

A majority of our clients have worked 30-40 years to accumulate enough money to support themselves for another thirty years outside the workforce. For them, the instinctive definition of investment risk is something like, “The possibility that a financial loss could ruin my retirement years.” It is specifically to deal with this real-life concern that we have evolved a two-stage process for 1) *assessing* the appropriate

level of investment risk for each client and 2) for *managing* investment risk through a creative and adaptive investment process.

Risk Management Is a Two-step Process

Every single investment is attended by some kind of risk; e.g. a risk that a loan will not be repaid, that an established business will be broadsided by an overseas competitor, or that rising interest rates will depress the value of your 30-year Treasury bond. The closest thing to a “risk-free” investment you can make is a 90-day fixed-rate loan to the government that prints the world’s reserve currency. The only problem is that the interest rate on that 90-day US Treasury bill is so tiny you need a magnifying glass to see it. So, it’s hard to build a pleasant retirement on a risk-free portfolio.

The fact that a safe, short-term Treasury yields less than 1% while a riskier “junk” bond yields more than 10% is perhaps the clearest example that **risk** and *possible return* are joined at the hip. Lower risk usually means lower expected return. The relationship of risk to return is mysterious and changeable, but you always find them together. They are the Yin and Yang of the investment proposition.



Keeping in mind that risk is not just theoretical, and that risks can result in serious loss, we believe that every investor needs to make a personal decision about the appropriateness of risk taking. That is the first step in our process for managing perpetual uncertainty.

Part I: Assessing how much risk is appropriate.

Since any investor needs to take *some* risk in his or her pursuit of a respectable return, each aspect (that is, the *risk* and the possible *reward*) begs inspection. The first part of managing risk for our clients involves our working together to understand the actual practical *goals* of their saving and investing efforts, and to help **quantify the lowest long-term rate of return that would comfortably achieve those goals**. We look for the *lowest* necessary return because at least theoretically it will point us toward the safest road to their intended destination. (Keep in mind that in every portfolio risk still exists, and it defies exact measurement.)

Knowing the lowest return that will achieve a client’s goal, we can propose two further questions that really help a person decide with some confidence ***whether a greater level of risk is worth taking***.

Question One: If your risk-taking should happen to pay off with a long-term return 5% greater than your minimum required return (say, 11% rather than 6%) how would that success affect your life? Your family’s life? Would it make possible a dream you have that we haven’t talked about yet? Would that be important to how you felt about your life?

One person might answer that it would make little difference to them; for example, a person whose retirement living expenses were more than covered by their pension. Yet another person might say that the possibility of having an extra \$500,000 at age 70, for example, would make possible a lifelong dream of funding a special needs scholarship at their alma mater. Thinking about this question can give a client an idea of whether the potential rewards of increased risk might be meaningful for them. Now you already know the second question...

Question Two: What if you take the extra risk, and the risk *happens*? Say you lose a third of your nest egg in pursuit of the higher return; how would that affect your life? Your family's life?

The way in which clients answer these two important questions helps us guide them in their selection of the Financial Advantage portfolio model with the most appropriate risk profile. Working through the retirement planning process with our client families helps us manage their investments to achieve their personal financial goals, not just to “beat the market” or to match some arbitrary benchmark that may involve an inappropriate degree of risk.

Part one, assessing the appropriate level of risk for each individual client, is often the most important step. Part two, assessing the riskiness and potential return of specific investments and assembling them into a balanced portfolio, is more complicated.

Part II: Balancing Risk and Opportunity ... the Investment Process

The first key is getting “the environment” right. Peter Bernstein is an enormously respected and widely read investment thinker who produced stimulating and insightful work concerning the management of investment risk for over 40 years. Peter passed from this life in June, 2009 at the age of 90. I have absorbed many of his articles and books and had the privilege of meeting him briefly on several occasions. Peter Bernstein, God rest his soul, remains a man worth listening to.



COURTESY: PETER BERNSTEIN

In a March 2008 piece called “**The Shape of the Future**” Peter waxed eloquently about a radical change in the overall economic and investment environment that he saw evolving. “Goldilocks is shredding,” he said, “to be replaced by something quite different; a whole new environment which we will only gradually come to understand.”

‘Goldilocks’ is a reference to that benign period, also known as “The Great Moderation,” which from 1981 until recently was characterized by *disinflation, shallow recessions, and low interest rates with abundant access to credit*. Not surprisingly, easy credit spawned a surge in consumer spending, a delightful steady growth in business profits and government tax revenues, unprecedented financial innovation and an explosion of speculation in real estate and stocks.

OK, Bernstein’s observations, written six months before the U.S. and European markets dissembled, was extraordinarily prescient. Now what? Listen to what he thought about the transition that is upon us: “Shifts to new environments are always attenuated,” Bernstein observed; “and they occur only rarely, which means most of us have limited experience with this phenomenon.”

He went on to explain that most market participants fail to see the shift to a new environment because mass thinking is dominated by the immediate past. That is why new environments, both prosperous and depressed, tend to drag on and on until the public figures out what is going on and then takes it to excess (either low or high.) For example, in 1981, following the Great Stagflation of the 1970’s, new Fed Chairman Paul Volker manipulated interest rates high enough to crush the then-exploding inflation rate; but because markets have a strong bias toward the recent past, treasury rates were still above 8% six years later even though inflation had been spiraling downward for years. “Clearly, nobody was willing to think about what the victory over inflation could lead to,” Peter wrote, “Yet it would eventually lead to ‘Goldilocks’ – a

remarkable change in the nature of the whole world.”

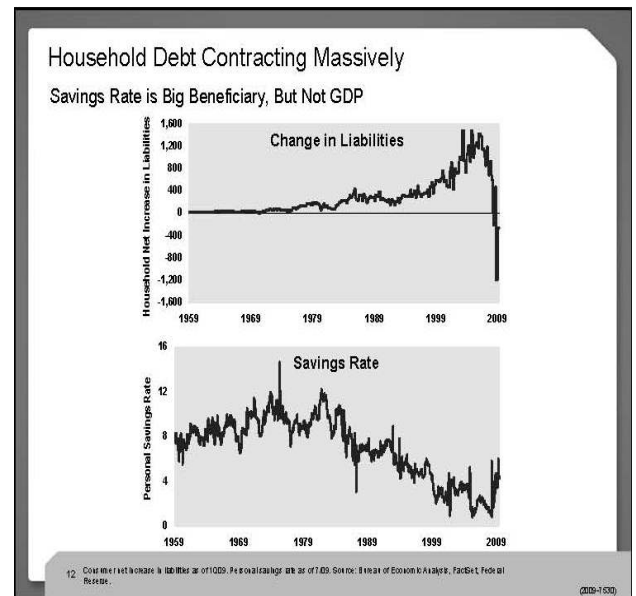
Now, at least if we listen to the media, Wall Street and spokesmen for the Treasury and the Federal Reserve, the dust seems to be settling on a very unpleasant recession; house prices have stabilized, the banking system is safe again and GDP is back in modest growth mode. Did we make it through? Is the huge stock rally signaling that the rain delay is over and the games have resumed? Or was Bernstein right that something entirely new is afoot? Was it just a nasty recession or the commencement of a completely new environment that we need to figure out?

The experts who now assure us that growth is back do lack credibility insofar as these same folks were not able to warn of the impending deep recession and credit crisis, were they? Even two years ago, few were wondering whether the government would need to engage in multi-trillion (Egads! Trillion!) dollar interventions into business and banking affairs. Now that this rather dramatic turn of events has already transpired, perhaps it behooves us to wonder a) whether high government deficits are a permanent or temporary feature of the eco-political landscape and b) to what extent and in what fashion this powerful shift is likely to influence the future returns on various sorts of investments.

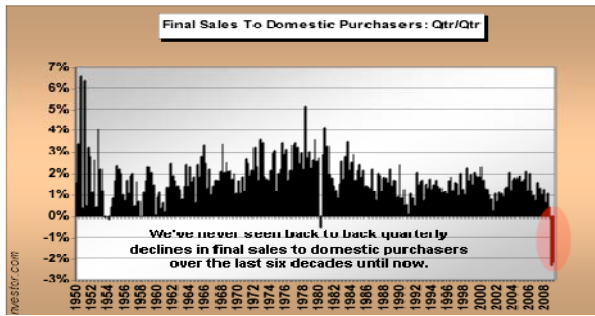
And it may even be worth asking how good is the data we have to work with? The Fed itself resists attempts to subject it to an audit, so we're all a little fuzzy about the extent of their machinations... the independent Congressional Budget Office (CBO) offers much more discouraging budget forecasts than does the Administration... China's exports, for which we do have confirming data, have fallen - 21% yet they claim 7% GDP growth... and our banks? Well, losses from syndicated loans (which have not been in the news at all until recently) have *tripled* this year, and we do not know how many residential foreclosures are waiting in the wings (one group estimates 7 million homes, equal to

more than a year's sales)... and Commercial real estate? Office rents are expected to have declined - 20% in '09 and to remain weak into next year, with vacancies soaring to 20%.

But the future behavior of consumers (who account for 70% of GDP) is perhaps the most critical conundrum. Retail sales figures have been wobbly, fading one week and hinting at stabilization the next. Economists see unemployment stuck near 10% for a while, so that is unlikely to cheer up shoppers. Household debt has contracted dramatically for the first time in 60 years! (See chart below)



It is hard to say to what extent this decline in consumer credit is the result of bank initiatives or consumers themselves consciously reducing their debt. Either way, combined with a rising savings rate and an unprecedented drop in final sales to domestic customers (see chart below) this data strongly suggests a cultural change is being imposed on over-indebted American consumers; a change so profound that it could define the new environment that Peter Bernstein foresaw.

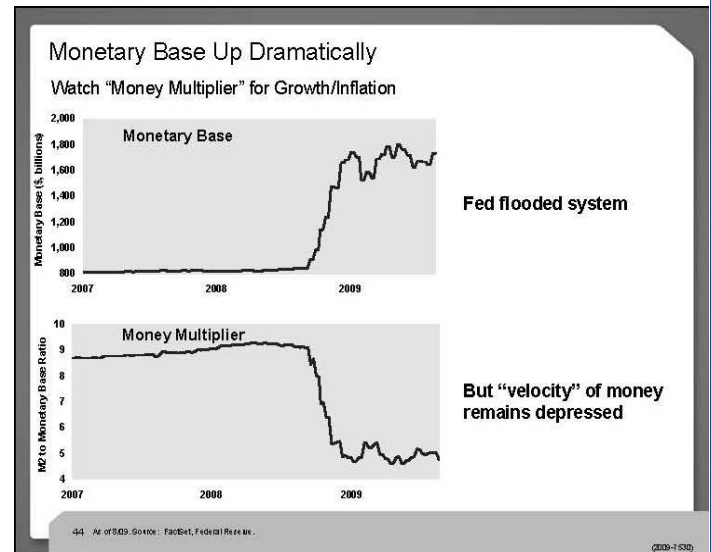


From the Great Moderation to the Great Fluctuation

In time, we'll know if the deleveraging process is a serious new reality to which capital must adapt or whether governments might succeed in their efforts to breathe new life into the late, great credit expansion. We have often commented in these pages that it is in the interest of governments and the political class to target an environment of 3% or 4% inflation. (For now, we will resist the temptation to repeat all the reasons.) But the jury is still out, and may be for a while, as to whether this policy goal can actually be achieved or whether one of the two unpleasant alternative scenarios will prevail. Curious investors want to know!

To wit:

- a) Broad deflation could result from high unemployment, underutilization of productive capacity, intense price competition among businesses vying for market share, destruction of lenders' capital by continuous defaults, and intentional deleveraging on the part of consumers and businesses. Falling prices for assets as well as goods and services, even in the face of staggering debt monetization, is not unprecedented (the last 20 years of Japanese experience comes immediately to mind), so this possibility has to be taken seriously. For it to develop, the velocity of money (see chart below) would have to spiral downward faster than currency and credit are expanded. Deflation could happen even if the government persists in printing money to bolster banks' shrinking capital bases.



- b) A resurgence of inflation or even hyperinflation is the other potential new environment toward which events may be propelling the world. We give the nod to the probability of inflation in this race; not because we'd *like it*, but because it looks more likely, although it may take a year or two to show up. The main reason is that if the private sector does continue to de-leverage, it seems very unlikely that the government would relent in its efforts to prop up credit. Several possible government scenarios warrant consideration:

- 1) For a government whose total debt is racing toward 100% of GDP (not even counting the almost unimaginable unfunded liabilities), the prospect of deflation is too horrible to contemplate. If deflation starts to become a problem, they will pour on the monetary heat, even though it might increase the possibility of a government credit downgrade, loss of reserve currency status, a global round of beggar-thy-neighbor currency devaluations and even hyper inflation. (This is a truly ugly scenario to which we optimistically assign a low probability.)
- 2) The fed has a dual mandate to target price stability *and full employment*

(since the passing of Henry Hawkins in 1978 when inflation was already a growing problem). It is clear to us that despite the inflation risk there is more political pressure to support the full employment obligation, especially since inflation actually benefits debtors, among whom the government is the 800-pound gorilla.

- 3) If the economy stalls, and stock prices start to tumble, there may well be another mass flight to the safety of government bonds. This would drive interest rates down, handing Washington a license to print money willy-nilly (albeit with awful long-term consequences).
- 4) Foreign central banks and sovereign wealth funds could reduce their propensity to buy US government debt, either because they have less surplus cash to invest, or because they tire of losing money in our weak currency, or as retaliation for US protectionism (which is already commencing). If that should happen, and/or if inflation starts to head seriously north, 10- year government rates will rise, putting pressure on the budget, crowding out corporate borrowers and depressing economic activity. It's hard to say how the Treasury and the Fed might react.
- 5) The looming Social Security and Medicare funding crises, even if they are not further exaggerated by nationalizing healthcare, are not going away, at least not without some wrenching alterations. These programs are actually in deficit right now, about 5 years ahead of expectation. Benefits will doubtless be compromised, taxes increased, qualifying ages increased and benefits

means-tested. But more monetization of federal debt is probably also part of the "solution".

The folks at Pacific Investment Management, better known as PIMCo, have earned enormous respect for their scenario work over the years. In a recent conference call they contrasted the likely characteristics of what they are calling the New Normal with the long era of easy credit and steady growth that preceded it. The Old Normal or Goldilocks or The Great Moderation dates back to the Bretton Woods monetary policy agreement near the end of WWII; the characteristics of the environment, especially in the last 25 years, were strong central bank control of monetary growth, low inflation and low real interest rates which gave rise to easy credit, low cost capital for funding productivity-enhancing innovations. The monetarily-induced recessions during this era were brief and mild. Business profit margins were 50% above normal levels. The consistency and predictability of growth stimulated an increased appetite for taking risk and eventually financial engineering (especially various forms of securitization by the shadow-banking system), a disincentive to save, and the rapid growth of consumer credit to fund consumption.

Inevitably, foolish credit standards resulted in soaring defaults, especially in residential mortgages, and the financial fabric began to unravel. Everyone is now up-to-date on the ensuing banking crisis and unprecedented government interventions. Here is what PIMCo sees ahead. First, a transition period while things get sorted out in the minds of investors. An environment of steadily disappointing financial news will reduce the appetite for risk at all levels of society. We'll be transitioning from rising debt leverage to de-leveraging, and from less regulation to more, and from globalization to de-globalization according to PIMCo.

The results will include slower *nominal* growth (3-4% a year instead of 6-7%) and a return on assets maybe half what business had gotten used to. Home ownership will likely fall back from 70% toward 62% where it was before because there are no sub-prime loans and a lot of people have lost their jobs more or less permanently. Since people's homes are no longer appreciating, savings rates which had fallen from 10% to zero will go back up and stay up.

Investing in the New Normal

With a clear idea of the likely economic environment in mind, (i.e. deleveraging, credit constraints, heightened government involvement, higher taxes, slow growth and an inflation threat slightly greater than a deflation threat) the next challenge is to populate the Opportunistic portion of our investment models. We recently updated our opportunistic categories (see last page of the July Blue Sheets) to help us target attractive stock and bond investments as well as new kinds of tactical investment positions designed to hedge the risk of scenario surprises and to take advantage of the volatility we think the markets will continue to exhibit as the financial world wrestles with all the new uncertainties.

Financial Advantage continues to invest in talent (two experienced CFAs have joined our team in the past month) and in the latest technology to aid our continuing pursuit of investment returns that will support the realization of our clients' dreams. In the next issue of the Blue Sheets[®] we'll discuss the structure of the portfolio we have designed to prosper in the era of heightened economic uncertainty, and describe some of the specific investments in more detail.

For the Investment Committee:
J. Michael Martin, J.D., CFP
September 29, 2009

DJIA 9750 **S&P 500** 1061 **NASDAQ** 2126 **30-yr Treasury** 4.03%

