



FINANCIAL ADVANTAGE, Inc.®

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The *Blue Sheets*®

Our quarterly commentary on the global economy and securities markets

Spring 2007

Bling-Bling and the Optimist (Part III)

Murph unveils the Financial Advantage Portfolio Strategy

Lunch at La Grenouille

When we last heard from BB, Rosy and Murph, they had agreed to lunch together at New York City landmark *La Grenouille* on 52nd between Park and Fifth. And so they did, on a warmish Thursday in May. Murph had agreed not only to present his strategy for a retirement portfolio designed to prosper in Tom Friedman's "Flat World", but also to pick up the not-insignificant tab in gratitude for his friends' influence on this strategy.

(To catch up on the spirited conversations that preceded this elegant déjeuner, please visit our website at www.FinancialAdvantageInc.com, where you may peruse the Blue Sheets of Summer 2006 and Winter 2006-7, titled Bling-Bling and the Optimist, Parts I and II).

George Murphy, "BB" Graff and Joel "Rosy" Rosen settled into the red leather booth at the far end of the dining room; a leafy bamboo provided an elegant partition from nearby diners. "So nice to see you this afternoon, Mr. Murphy," said the Maitre d', nodding deliberately in a way that almost suggested a bow. He raised a finger and the tuxedoed sommelier appeared with a chilled bottle which he held out to Murph. Smiling his approval, George Murphy received the bottle and lifted it before his obviously-impressed friends. "And now, from the first year of this most promising millennium, a year that was not so favorable for investors but very kind to grapes in the Loire valley, I offer you, my good friends, this Pouilly Fumé "Baron de L" 2000. When each delicate glass had received its precious fluid, the three friends lifted them in a toast as Murph intoned:

Murph "In the last few months, you have graciously shared with me your wisdom concerning the complexities of our global economy and capital markets. I have pondered your insights and found them enormously helpful in developing a realistic strategy for investing clients' money in our unstable world. For your invaluable assistance I am in your debt. *Votre santé!*"

All (Amid copious clinking) *Votre santé!*

For the next 10 minutes, Murph, BB and Rosy busied themselves with menu considerations. With these important decisions out of the way, Murph began to explain to his friends the investment strategy which he had evolved in the weeks since the last meeting of the triumvirate.

FAI's Portfolio Strategy (according to Murph)

Murph: I should begin by telling you that I took to heart Rosy's recommendation to read Tom Friedman's "The World Is Flat". I found it provocative on several levels. His catalogue of evidence regarding recent profound changes in global commerce is enlightening. It is a wake-up call and a great service to those of us trying to understand how technology and national interests are dramatically changing the way the world works and what the implications might be for the future.

Friedman's book and our recent discussions together have helped me rationalize what I had realized instinctively over the last few years... that when the world changes around you, your investment style needs to adapt. Our globalizing economy and fast-changing capital markets demand a creative new strategy. Folks who continue to do what worked in the '80s and '90s (like indexing) will miss new opportunities and fall prey to new risks.

I have thought carefully about all your insights as well as your admonitions. I've found your observations very helpful in developing a realistic strategy for investing clients' money in a world brimming with exciting new opportunities and, of course, with some very frightening risks as well.

Today it's my turn to share how our investment strategy is designed to adapt to this world of new realities. Keep in mind that my responsibility is to design portfolios for people who are retired or about to retire from full-time employment. Some of our clients are wealthy, but most are ordinary upper-middle-income Americans who have saved all their lives and who will depend on their investments to enjoy a satisfying retirement that could last 30 or 40 years. For this reason our first concern is to conserve their capital,

followed closely by our second objective... keeping it productive. So here goes...

Allocation to Stable Assets

Murph When we design a new portfolio, our first consideration is to decide on an appropriate allocation between "Stable" assets and "Opportunistic" investments. This judgment is based on the long-term return each client needs to support his or her retirement goals, and how much their plans might be affected by even a temporary decline in portfolio value. We maintain four internal "models" to reflect different clients' tolerance for short-term fluctuations.

Currently, our allocation to "Stable" assets ranges from 30% in our more aggressive portfolios to as much as 60% for our most conservative clients.

Rosy 30% to 60% in "safe" assets! That's pretty hunkered down, isn't it Murph?

Murph Well, yes, it is. Besides trying to accommodate our clients' stage-of-life risk preferences, our Stable allocation is currently elevated to reflect our concern about overall market risks. Our "B" model is 40% Stable and 60% Opportunistic right now; if we thought the market was sensibly valued it would be 70% invested in the Opportunistic group, or even 75%.

In the present interest rate environment, Stable assets such as money markets and short-term Treasury bonds provide an income return of nearly 5%. So the more money we try to shelter in these liquid but low-return securities, the harder our Opportunistic investments need to work to reach our return goals. OR, the longer we might need to endure low overall portfolio returns while we wait for the market to present us more attractive values in the Opportunistic categories. For most of our

clients, either of these alternatives is more acceptable than actually losing money on paper for a year or two or three.

I guess you could say our investment style is in the “slow and steady wins the race” category. Said another way, *we are focused on earning an adequate return over an entire market cycle, and with a minimum of stress for clients!*

Rosy I prefer a little more adrenaline!

BB Me too!

Murph I understand; I really do. Capitalism *is* partly about excitement and possibilities. But you need to appreciate that investors view the world differently when they are no longer adding new money into their portfolio every month. See, for *you*, a decline in stock prices has a benefit...it gives you an opportunity to pick up bargains. Even if the price of your best stock falls, you can always wait it out and eventually expect it to recover, right?

Both Right.

Murph A person who is *taking spending money out of his portfolio* every month receives no benefit from falling stock prices, unless he has kept a lot of “dry powder” in the form of stable reserves. And the money he takes out to spend is no longer there to recover. So, a retiree is not that keen on adrenaline in her portfolio! On the tennis court, yes! On her monthly statement, not so much! A steady return makes the rest of life more enjoyable.

I know you gunslingers think this is boring stuff, but even making stable asset decisions requires continual monitoring. If money market instruments pay 1% as they did a couple years ago, you may need to own short duration bonds instead. Or today, do we put all our liquid assets in the money market which yields as much as 3-year treasuries? Well, not necessarily. I

think there is a reasonable possibility that short-term interest rates may come down again, creating appreciation in 3-year Treasuries.

BB You think the Fed is gonna *cut* rates!?

Murph I am convinced that the Federal Reserve Bank is more concerned about keeping employment growing than about controlling inflation. If the weakness in housing persists (I give it a better-than-even chance) I believe the Chairman will think it his patriotic duty to cut the short-term rate in a bid to boost the economy. In that event, we could earn a little more in Treasuries than in money market funds. So we are about equally divided between the two.

BB What about long-term rates? Whaddya see there?

Murph First, long bonds are not “stable” assets because they are so sensitive to rate changes. So when we own them they are treated as an Opportunistic asset, meaning we would buy them for appreciation potential. I think that’s a shaky bet right now with inflation risk rising. Since you asked about inflation, let me touch on it; I think it is becoming one of the four major risks... valuation, geopolitical, inflation and financial leverage.

There’s a standing joke about the Fed using “core CPI” (which excludes food and energy) as the inflation index they rely on to decide monetary policy: it’s a good index for a planet where people don’t eat or drive cars! But it’s starting to be less funny as the all-in CPI stays stubbornly above the “core” number. In the first four months of this year the CPI rose at an annual rate of 4.8%, up from 2.6% for all of 2006. When you exclude food and energy, the “core” increase was only 2.2% through April, down from 2.6% for all of 2006.

In preferring the core number the Fed assumes that food and energy prices will continue to fluctuate up *and down* as they have historically. But we are concerned that they may keep rising because of two *fundamental* changes:

1) Energy demand keeps growing while supply struggles to keep up.

2) Food prices are being driven up by new forces:

- a) The ethanol industry's enormous demand for corn, which is driving up the cost of sweeteners and of feeding hogs and cattle.
- b) The permanent new reality that more and more Asians can afford a better diet and personal transportation. Yes, food and energy! China, by the way, already has a shortage of arable land.

There are also two reasons we're concerned about a rise in *general* inflation:

1) Import prices, which have been a major disinflationary force in recent years, may be heading higher. The Chinese money supply is virtually out of control, causing their inflation to ramp up; they'll pass that on to us!

2) Money supply is rising in double digits in most of the world, including the US, and price inflation is essentially a monetary phenomenon.

The Japanese and European Central Banks have already switched to an all-in version of their CPI. Do you think bond traders might be a little shocked if the Fed did the same? It is not inconceivable. And whether the Fed gets real or not, the market can.

Rosy So you are avoiding long-term bonds. How else is the inflation risk reflected in your strategy?

Murph We own some TIPS and some gold bullion and we have a major exposure to energy. Which is a good segue into our Opportunistic portfolio.

Allocation to Opportunistic Assets

Rosy: OK, Maestro, let's get on to the good stuff. How do we make *real money*!?

- o What are your Opportunistic investments?
- o How do you diversify them?
- o How do you design a portfolio to benefit from globalization, technological change and financial innovation?

BB: Yeah. And what do you do about

- o Inflation?
- o Energy shortages?
- o An over-extended consumer?
- o Terrorism?
- o Currency devaluation?
- o An overvalued market driven by borrowed money?

I can't wait to hear!

Murph Hold your horses! I'm about to tell you the whole story.

Using our "B" model as an example, we're trying to average 7% *or more* annual portfolio returns *after expenses* over a full market cycle. Since we expect to earn just 5% in Stable assets, which are currently 40% of a portfolio, then we need to aim for about a 10% average return in the "Opportunistic" part of our portfolio.

Rosy Heck, you can get that with an index fund, can't you?

Murph Maybe, if you have a 30-year investment horizon, since 10% is the long-term

average return for U.S. stocks. But if you are retired and expect to make some withdrawals from your nest egg, your horizon is much shorter. Especially if you happen to retire at the beginning of a multi-year market slump like 2000-2002.

If a 65 year old retiree indexed 60% of his \$1 million nest egg in the S&P 500 at the beginning of this millennium, and withdrew \$50,000 a year, at the end of 2002 his portfolio would have shrunk to about \$600,000 and he'd be just 68 years old. That's a real "feel bad" situation. See what I mean?

So let's address your market valuation question briefly, because it has a lot to do with expected return. Wall Street, which exists to *sell us* securities, tells us every day that stocks are cheap based on the Price/Earnings ratio. In actual fact, stocks are pretty *expensive* on their P/E. The Street compares the average historic P/E of 15 (which is based on *actual* earnings) with today's P/E on *estimated future* earnings. There's an apples and oranges thing right off the bat. The market is now 18X actual earnings but 15.5 X on *estimated* earnings. A bigger flaw in their argument is that they do not analyze the historic P/E for the impact of the earnings cycle. If they revealed that the average historical P/E when profits were at a cyclical peak (which is the case today) has been less than 10X we would see how much risk there is in a market selling at 18 times cyclically high profits!

Because of valuations, we think stocks are riskier than normal. We do not want to own broad indexes. To earn 10% in our Opportunistic categories will require some very good judgment in asset allocation and securities selection. That is where your insights about trends have provided some helpful perspective.

You asked about diversification, and I think that is the single most important

quality a manager can contribute to a portfolio. Diversification means to see that a portfolio's investments do not all march to the same drummer; that they are, to use the jargon of the day, uncorrelated. Most managers attempt this by investing in all the "style boxes". Our approach is significantly different.

Several years ago we realized that the popular division of stocks into style boxes based on their market capitalization and whether they are "growth" or "Value" stocks is not an effective method of diversifying because there is no cause and effect relationship between these "styles" and actual returns. Instead, we created 12 investments categories differentiated by the economic fundamentals that drive their returns to investors. (Murphy holds up a spreadsheet showing four major classifications: Income Producing, Macro, Superior Value & Competitive Advantage, each with three sub-groups.)

Our experience so far is that the investment returns from our different groups vary a lot from one to the other for reasons that can be analyzed and even predicted to some degree. As we have discussed before, the great influx of (mostly borrowed) risk capital into the public securities markets the last several years has compressed risk premiums across the capitalization spectrum. Inevitably, investors will get hurt after a happy few years, and they'll once more become aware of risk and start to price securities accordingly. We think our fundamental approach to diversifying our holdings offers some protection against that eventual return of risk awareness.

We think it is neither prudent nor necessary for diversification purposes to invest a little bit in every cap size, every industry and every country. It makes more sense to us to diversify according to the way investments are likely to behave in a range of possible future scenarios based on

their fundamentals. We endeavor to make securities selections based on the present value of future cash flows. We are content to avoid whole sectors whose fundamentals or valuations are extended, and to concentrate in sectors with good fundamentals and reasonable values. Our portfolios look different from a traditionally-diversified portfolio that owns some of everything, but we think ours will provide a *better* and *more stable* return over a market cycle.

Rosy Good! So you load up on technology and Asia because their growth is unstoppable, right?

BB Nah! You load up on oil and gold because “they’re not making any more”, right?

Murph Actually, I’m influenced by both of your opinions about the way the world works. I do think technological improvements are unstoppable as long as people are free. I also think Asia *will* grow faster than the industrial West, though there’ll be dramatic disruptions along the way. We are studying some direct investments in India, but I cannot imagine putting clients’ capital at risk in China, a communist country where the rule of law is sketchy at best. (And need I mention that they have a nuclear arsenal, a long history of popular uprisings and half the loans in the state-owned banks will never be repaid?)

I believe we can more safely and more profitably invest in the *consequences* of China’s rapid growth in the rest of the world, mainly in the impact of their ravenous requirements for energy, food and all the components of infrastructure.

I know we can’t stay here ‘till supper, but let’s touch briefly on energy. On the *demand* side, it is no secret that if China and India continue to grow two or three *times* as fast as the industrial countries, strong demand is assured because these emerging economies are in the energy-

intensive phase of their development. Where there is more disagreement is about the *supply* side. This is the uncertainty that keeps the stocks cheap. If BB is essentially right that energy supply will remain constrained then you *should* “load up” on oil and gas, because the reality is these will be our energy foundation for years and years and prices are likely to be in an uptrend.

But if the supply should *rise* in response to rising prices as classic economic theory proposes, then energy may not be such a slam dunk. We have researched the so-called alternative fuels and arrived at a conviction that solar, wind, and fuel cells will make small contributions at the margin. Coal has a solid future as a power plant fuel, but is becoming increasingly capital-intensive because of pollution-control requirements. Nuclear will have a prominent role but, in the US, the regulatory lead times are terrific! Overseas, it’s a better story.

We believe LNG (liquefied natural gas) will be imported here to supplement our declining domestic gas production, and that gas prices will remain high because it is the most desirable fuel for electric generation and home heating. As to oil,

two-thirds of its demand is for transportation fuel and there are no serious competitors on the horizon. Ethanol from corn, in my opinion, is a waste of American money. It costs more to produce than regular gasoline, it takes more energy to produce than it provides as a fuel, it is corrosive to engines and pipelines and, perhaps more damaging than everything else, it drives up the price of food, particularly corn, wheat and meat.

Where does that leave us? With oil and gas, which are getting more and more expensive to find, to produce and refine. Some of the largest spenders have been unable to grow their reserves. In our

portfolios we currently own stock in five outstanding companies that benefit from the tight supply/demand picture for energy: two that are not household names are Apache and Dresser-Rand.

Apache (APA), an American oil and gas exploration and production company, is our largest single stock holding. They have grown production and reserves-in-the-ground in all but one of the last 21 years! Their reserves, about half gas and half oil, are in politically safe parts of the world, with 83% in the U.S., Canada, The North Sea and Australia. The balance is in Egypt and Argentina. APA's balance sheet is very strong, and management has proven itself outstanding in the allocation of capital to new projects. Earnings are four times what they were four years ago. Yet the shares sell at only 11 X earnings and 6 times cash flow, substantially below the industry average.

Dresser-Rand (DRC), is a leading supplier of highly-engineered rotating machinery such as compressors and turbines to virtually every sector of the energy business. Customer industries include drilling rigs, offshore oil producing platforms, gas and electric utilities, pipelines, refineries, coal gasification, LNG, and even ethanol. The tight supply/demand balance for oil and gas has stimulated equipment demand across the spectrum. Orders have doubled in 3 years, profits have tripled, and there is still significant room for margin expansion. The company's business model requires relatively little capital spending, and cash flow is being used to reduce debt dramatically. We recently trimmed our holdings by 1/3 at a 50% gain, an example of our rebalancing discipline. If the backlog

and profit margins keep improving, DRC will continue to be a very productive long-term investment.

We are currently researching several potential new investments in Canada and a major international mining company to more broadly diversify our commitment to natural resources as a way of profiting from Asian growth.

Rosy No Technology? Don't tell me there's no technology!

Murph Of course we have technology, Rosy. There's lots of very high tech in our energy companies, for one thing. Technological change is everywhere, but we won't just throw money willy-nilly at exciting products. It is very hard to make money as an outside investor in fields where the game changes every 6-12

months, so we need to be thoughtful, price conscious and early! I'll tell you about two tech investments we do have. One is a mutual fund and one a stock.

BlackRock Health Sciences Opportunity (SHSSX) gives us research and diversification in the health care arena at a very reasonable cost of 1% (the annual expense ratio for these institutional shares). This no-load health/biotech fund has earned Lipper's top ranking for total returns and consistency of returns. It earned our clients 24% last year and over 11% so far this year, beating comparable funds.

MoSys, Inc. (MOSY), is an \$8 stock with \$2.50 a share in cash and virtually no debt. There are no factories and operating margins are almost 90%! But earnings are very slim so far; we own this stock expecting a breakout in popularity of its principal product: designs for microchip systems that increase

speed and memory and reduce power consumption by large percentages. MOSY licenses designs and technical assistance to a long list of high-visibility customers who produce battery-operated consumer products like cell phones and games. We own MOSY for the big operating upside as well as takeover potential.

Summary

Murph So let me wrap this up while you're enjoying the best chocolate mousse on the planet...

I think today's big risks are high valuation, unprecedented financial leverage, inflation, geopolitics/ terrorism, and an unexpected recession. The defenses we have built into our portfolios include a) larger than usual reserves, b) investments that may benefit from inflation, chaos or a flight to safety such as gold, Treasury Inflation Protected Securities (TIPS) and commodity producers, and c) a short position against the NASDAQ 100 and Russell 2000 indexes.

On the bright side, we own some very well-run businesses that can succeed in a "flattening" world even if the wheels get a little wobbly on the global economy from time to time. And if a bear market should make them cheaper, we would be *delighted* to use reserves to increase our positions. Finally, we have some proven managers working for our clients in five carefully chosen equity mutual funds, each conducting its own unique value discipline in securities markets all around the world.

Safe home!

We've been asked, "If you're so worried about all these problems, why do you have more money in equities than anything else? The reasons are 1) that we cannot expect to earn enough in stable assets to reach our clients goals; 2) We cannot know when the problems will manifest themselves and investors begin to flee; markets can remain oblivious to risk for a long time! And 3) Like you, Rosy, we are believers in the ingenuity of man, especially of free men. Over the long haul a rising standard of living seems a rational expectation, and that should provide a backdrop for prosperity for careful investors.

Rosy Murph, I still lean toward a more adventurous style, but as you say, it fits my situation. Still, you have convinced me to go home and increase my reserves! And, oh yes, lunch was beyond expectations! You are a man of your word!

BB Murph, thanks so much for the beautiful lunch and good company. I am still a little more bearish than you, but I think you have struck a very practical balance.

Murph Fellas, each of you has had an important influence on our current strategy, and I thank you sincerely. If our portfolio prospers in the year ahead, it will be my great pleasure to celebrate by inviting you back together with your lovely wives for a splendid dinner party, and we shall enjoy together a Château Figeac, St. Emilion 1999; a fitting way to remember that most extraordinary year for technological innovation and for Wall Street!

For the Investment Committee:
J. Michael Martin, J.D., CFP
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DJIA 13,441 S&P 500 1,507 NASDAQ 2,537 30-yr Treasury 4.97%