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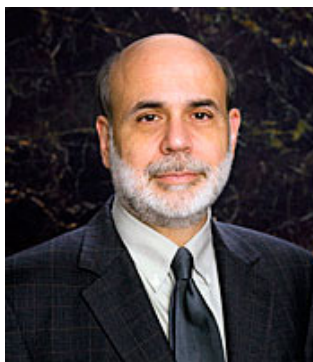
## The *Blue Sheets*®

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

*February 2009*

### *Can Tim, Ben & Barney Pull This Off?*

*The answer matters profoundly*



*The most valuable advantage in the battle for investment survival is to understand the context \*in which we are making investment decisions; that is, to correctly appraise the economic and political forces that are shaping tomorrow's risks and opportunities.*

*To observant investors, the collapse of global securities markets and the near hysterical efforts by governments to stop it signal a global contextual transformation that will be broader, deeper and more pervasive than any disruption since WWII. As everyone now knows, this upheaval was triggered by the implosion of the postwar credit expansion which had soared beyond the limits of prudence during the last five years. The resulting devastation to the world's financial institutions launched a self-reinforcing contraction of economic activity as buyers and sellers of goods and services retreat to survival mode; every day the list of defaulting borrowers lengthens and the cohort of willing lenders shrinks. We find ourselves in an economic vortex; **the temporary context is fear, but in this cauldron a brand new context of opportunity is brewing.***

*For a generation, our investment context was characterized by the dismantling of the socialist Soviet Union, the upsurge of capitalism in Asia and Eastern Europe, the internet revolution, the global credit boom, trade boom, housing boom and energy boom. As the credit cycle crashed, our widescreen, Technicolor, hi-def view of a familiar and prosperous future has gone suddenly blank! How America and the rest of the industrialized world deals with the deflation of its puffy balance sheet and the accelerating economic contraction will largely determine tomorrow's investment context. Owners of private capital throughout the world are scrambling to secure what resources they have left, and to position themselves for whatever the new context is going to be. Success awaits the thoughtful investor; disappointment the fearful one.*

*\*Merriam-Webster: **Context**...the interrelated conditions in which something exists or occurs.*

*In this issue of The Blue Sheets®, we offer some observations on a subject that most of our mothers taught us not to discuss in public... politics. We make bold to enter the wilderness of political discourse with the understanding that our readership is as profoundly divided as is the country at large about the wisdom of this or that “solution” to the problem of too much debt. We do so for the simple reason that we cannot ignore the blinding speed with which financial power is being assumed by central governments and surrendered by some representatives of the private sector. We think it does not overstate the case to suggest that the current debate about bailouts and stimuli has the makings of an epic struggle capable of defining the American investment context beyond the life expectancy of our youngest readers.*

## **We’ve been here before**

The media have publicized all the “government rescue” data that is available, so we needn’t recount the enormous proposals. Two things strike us most: the *scale* of government plans for intervention in the economy, and the apparent *ease* with which it is being accepted, even *welcomed* by much of the electorate. Fear seems to have changed Americans’ views. In 2002 there was a public outcry over a \$400 billion deficit. Today, we’re staring down the barrel of a \$2 TRILLION shortfall in our federal budget. That’s more than a 20% increase in total outstanding Treasury debt in ONE YEAR, with *more to come*.

Government’s stated intent is to minimize the depth of the recession by restoring access to credit for businesses and consumers, thereby allowing economic growth and job creation to resume. Is it wise? Will it work? **CAN it work?** Can Tim Geithner, Ben Bernanke and Rep. Barney Frank (Chair of the House Committee on Financial Services) pull off this rescue? **Neither the feedback from the stock market nor reason nor the evidence of history offers much encouragement.**

On February 10, newly appointed Treasury Secretary Tim Geithner held a news conference to present the Administration’s bank rescue plans; based solely on the 4.7% plunge in stock prices that day, Geithner’s sketchy outline of the plan was roundly booed by investors. In whatever form it eventually takes, the government’s **bank bailout** will be accompanied by a quickly-crafted \$800 billion **economic stimulus** package (the actual eventual cost of which some place at \$2-\$3 Trillion). The hoped-for effect, of course, is to “create jobs and get the economy back on a growth track.”

Is the purpose itself (stopping the de-leveraging process by propping up lenders and borrowers) a worthy one? Or is the reduction of the world’s debt burden something that must eventually take place to restore economic health? Can jobs actually be created by government spending of money that must eventually be gotten from future generations by either a traditional tax or by inflation? Does intervention fix a problem or only postpone the day of reckoning? Here is a credible answer from the history books...

In May 1939, nearly 70 years ago, FDR’s Secretary of the Treasury Henry Morgenthau offered a pessimistic appraisal of the huge government programs over which he had presided for seven years; he said, “We are spending more money than we have ever spent before and **it does not work**. I want to see this country prosperous. I want to see people get a job. We have never made good on our promises. I say after eight years of this administration we have just as much unemployment as when we started, and an enormous debt to boot.” In 1939, 20% of the workforce was still unemployed despite budget-busting federal outlays to rev up the economy.

## This question *demands* an answer

We don't think you can cobble a sound investment strategy without first answering the main question about the investment context: ***Will the aggressive package of government spending and guarantees jump-start our economy and get it running smoothly again?*** YES or NO?

YES  NO

Whatever judgment history will ultimately render, the scale of government interventions in economic affairs is so great, not only in the US but around the world, and the pace of proposals so swift that an investor must decide whether the past context of economic growth can be restored by such interventions or whether a very different future awaits us. In our opinion ***there is no hiding*** from this question: not for the well-off retiree who only hopes to preserve the buying power of his or her nest egg, and certainly not for the pre-retiree or mid-life saver struggling to build a financially secure future.

An answer to the question is a necessary prerequisite to designing a successful portfolio. Having chosen YES or NO, the prudent investor will also want to keep his or her options open by *designing liquidity and flexibility into the portfolio* so that if events should make their original answer seem unwise, a change of course can be arranged.

**Our appraisal is that these enormous government programs will eventually prove to have been a mistake**, an interference with the market process on such a grand scale that it will only succeed in growing our national debt, raising our tax burden, raising interest rates as well as the risk premium for equity capital (i.e. lowering the prevailing P/E), reducing risk-taking and innovation, and generally impairing this free-market economy which has for so long been the envy of the world.

We are building portfolios with the expectation that a restoration of economic growth is probably still years away, that stock prices still reflect an unrealistic expectation for early recovery; that interest rates on government debt are artificially low and will eventually be driven higher (treasury bond *prices* lower) by greatly increased inflation expectations. ***We are in a transitional investment context that requires a kind of diversification quite unlike the formulae that worked during the long credit expansion.***

There are several reasons for our conviction that the smorgasbord of expensive government programs is unlikely to re-energize our economy, and more likely to increase its already unbearable debt burdens and to warp some of its most virtuous characteristics.

- a. Though no two periods are identical, the history of similar government efforts in similar circumstances does suggest the burden of proof rests on the optimists. We have in mind the efforts of the Roosevelt Administration to deliver us of the Great Depression (see Morgenthau, above) and the dismal failure of Japan to orchestrate a recovery during its "lost decade" of the '90s by artificially depressing interest rates, propping up banks and spending a trillion dollars on stimulus.
- b. More than 70% of our country's GDP is the result of the individual decisions of its 300 million free citizens. While but a modest fraction of them have borrowed themselves silly, most people are affected by and influenced by the political speeches designed to generate fear, and by daily updates on unemployment, bankruptcies and other such unpleasantries. The understandable

reaction of the average citizen is to hunker down, cut their spending and increase their savings. While this is the right and healthy response, in the short run it is contractionary and deflationary... the opposite of the government's purpose.

- c. With a big assist from Chinese imports, for most of the last 25 years the central bank has managed to keep inflation in the 2-3% range; slow inflation makes long-term debts easier to pay back but doesn't scare consumers into hoarding (as when they expect high inflation) or postponing purchases (as when they expect *deflation*). The current recession-cum-credit-contraction has been deflationary, most notoriously in the housing sector, which provides a financial incentive to put off buying that first home. Much of the money government is throwing at the foreclosure problem will only underwrite re-financing of existing mortgages, doing little to remove the inventory glut, and deflation will continue to de-incentivize would-be buyers.
- d. Realistic assessments of the "job creation" potential of the stimulus programs seem smaller than the job losses being announced in the private sector. Furthermore, although no one source seems able yet to offer a list of the actual federal projects buried in the stimulus bill and the dollars allocated to each, it has been widely reported that many of them will not actually get under way for three or more years, providing no near term boost even of the kind sought by the ruling Keynesians.
- e. But **the most compelling reason** of all for the expected failure of government spending to revive the over-indebted economy is that the government is

*borrowing* the money it plans to spend. The essential problem is too much debt for a healthy economy to carry, so **how is more debt going to fix the problem of too much debt?** Good question, we think!

OK, if we turn out to be right that, other than a short-term blip on the GDP screen, massive government stimulus seems unlikely to get the economy growing again, then what will our investment context look like? What are the biggest risks and where are we likely to find opportunities for private capital to earn a decent return?

### **The investment context, then and now**

From 1982 to 2000 investors made a lot of money, right? Bonds appreciated because interest rates were falling, and stocks went up because *both* earnings and P/E ratios were rising. If we understood just the following four key elements of the investment context in 1982 we would have enjoyed astounding returns to our invested capital:

- a) We were in a typical business cycle recession that, with help from monetary policy, would soon correct itself.
- b) Interest rates were HIGH relative to long-term inflation trends, and likely to fall.
- c) P/E ratios were LOW relative to normal earnings on normal profit margins, and likely to rise.
- d) "You'll never go broke betting on the American Consumer."

Perfect hindsight, right? Sure, but these key points were actually discernible in 1982. Maybe the interest rate thing was clouded by the preceding rash of double digit inflation, but Paul Volker's Fed had already taken a bold stand by inverting the yield curve with sky-high short-term rates, and the return to normalcy was

already underway. The pro-free markets Reagan administration had already taken over the Executive Branch, and the rest as they say is history.

Well, what is the investment context today? And what is it telling us? It tells a very different story from 1982! Here is today's version of those four key elements:

- a) We have begun our second year of an economic downturn which is NOT a typical business cycle recession that can correct itself any time soon. Those earlier downturns were inventory recessions and each was softened by accommodative Fed policies; *this downturn* is due to the sudden *reversal* of a generation-long credit boom, and it will take years to adjust to. We've already seen that unprecedented monetary ease and fiscal stimuli have so far proved unable to turn the tide.
- b) Long-term treasury interest rates are at an absurd LOW relative to long-term inflationary trends, and especially relative to the probability that government's "quantitative easing" will dramatically increase future inflation. Government interest rates are artificially low and likely to rise.
- c) At 30 times estimated S&P 500 reported earnings for 2009, P/E ratios are still HIGH. P/Es are not low, as Wall Street would have us believe; what analysts are missing is that the swollen profit margins of recent years were an *extraordinary and temporary* benefit from credit-driven consumer exuberance, and will not be seen again until the nation's debt is right-sized, if ever!
- d) "You'll never go broke betting on the American Consumer" is about to be retired as a dependable investment

principle along with such worthies as "Buy as much house as you can afford" and "stocks for the long run". The vaunted consumer is finally being driven into retreat by his/her creditors and may not be restored to full shopping strength for a surprisingly long time! Saving money is "in"! A debt-free car with 100,000 miles will become the new badge of honor at your neighborhood block party.

### **In a nutshell**

Here's a thumbnail of the current situation that every investor needs to have in mind as a context for decision making. For over a quarter century, Americans and their government binged on consumption and eschewed savings, giving a bad example to the rest of the industrialized world. Consumer indiscretion provided a heady operating environment for most businesses, replete with record high profit margins; and the long consumer boom culminated in beautiful bubbles for house prices, stock prices and commodity prices. The bursting of those bubbles is already in the history books along with tulip bulbs and other manias. But the consequences of the credit boom and bust linger on.

What consequences? Well, debt mostly. There is a Wall Street adage that says, "***Every debt will eventually be discharged; either by the borrower*** (repayment) ***or the lender*** (write-offs)." A visitor from Mars who spends 5 minutes in front of CNBC will understand that lenders and borrowers (and their respective representatives in the nation's Capitol) are locked in an epic struggle to determine just how our \$52 Trillion mountain of interest-bearing obligations is going to be discharged; or at least right-sized to a bearable debt service figure that will permit our aggregate economy to grow again. How this struggle is decided will largely

determine where investment opportunity will emerge in the next five or ten years.

### **Freedom... the reason for optimism**

Lord Acton (1834-1902) famously observed that, "Power tends to corrupt; absolute power corrupts absolutely." And later, "The danger is not that a particular class is unfit to govern. *Every* class is unfit to govern".

Acton would have maintained that the current government vs. private sector debate is not a matter of this party vs. that one, but a matter of the best arrangement for coping with this persistent human weakness, our tendency to abuse power. One of the most profound yet little-celebrated aspects of free market capitalism is that nobody is in charge; power is dispersed. Each participant in the daily struggle to secure bread and dignity is free to make decisions in his or her own interest, to aid those whom they choose to aid, to take risks and suffer or enjoy the consequences. I can offer to sell you something but you only make the transaction if it pleases you. Freedom!

If you or I, dear reader, should one day find our personal debts unmanageable, perhaps due to a reversal in our business interests, we could expect to be stripped of our business, our homes and our reputation as a credit-worthy borrower. And we would have only our own imprudence to blame, would we not? As our parents taught us, behavior has consequences.

But let a significant percentage of the electorate find itself financially underwater and the political class will perceive an opportunity to swim to their rescue. In fact, this is the situation in America today. Perhaps the greatest risk to the prosperity of our grandchildren is that today's voters might accept a national policy that henceforth the just debts of certain people (those

lucky enough to be designated by certain employees of the Sovereign State) will henceforth be discharged neither by the imprudent borrower nor the careless lender but by taxpayers.

By taxpayers, of course, we mean those citizens fortunate enough to still earn a taxable income, *and* who have chosen *not* to incur an unmanageable amount of personal debt. So much for the sobering influence that probable consequences are expected to have on people's behaviors. This is the very condition contemplated in the insurance industry's expression, "moral hazard". Public policy that invites moral hazard can easily lead to anarchy or totalitarianism and is for that reason devoutly to be resisted. What appears to be "a search for the solution to the credit crisis" could easily morph into something closer to a contest between the ideas of socialism and collectivism vs. those of individual responsibility and free markets. Is this too extreme a view of what is going on? Let the debate rage on!

For this writer, it is sad to see the President of the United States, the most free and most prosperous country in the history of the world, and its Secretary of the Treasury and the Chairman of its Central Bank and Chairman of its lawmakers' Finance Committee, filling the TV screen day after day to lament that unless *they* "do something" we will all be selling apples to one another on the street corner. Is it not the hard work, creativity, personal responsibility and integrity of free men and women acting in their own self interest that best explains the amazing prosperity of the western world?

As we search for investment value and opportunity amid the rubble of the last cycle, and while shareholders and politicians grope for acceptable compromises to dispel the gloom which we have visited on ourselves, we remain

optimistic that the virtues of freedom enshrined in our founding documents will be appreciated anew in our land. But in the meantime, to keep one another aware of the risks to freedom of unbridled government seems a worthy mission.

## “Bad Bank”? Bad Bank!

### What we need is a few GOOD BANKS!

There is a great deal of serious discussion about a proffered solution to our debt crisis called “A Bad Bank”, i.e. a new institution created specifically to buy the non-performing loans that are crippling the balance sheets of existing banks, especially the very large ones. Proponents claim that, by thus improving existing banks’ balance sheets, they would be free to crank up their lending activity again.

What in the world would actually happen to all those “toxic assets” bought by the bad bank is so far unclear. And how much money the government would take from taxpayers and hand over to existing banks in exchange for these awful loans that they made just a year or two ago is also unspecified. We’ve seen loss estimates of \$1 to \$2 Trillion! And *who would decide* how much to pay for paper that may be entirely worthless? These are just some of the contentious aspects of the bad bank concept.

Are voters to believe that this would somehow make the bad loan problem magically disappear? Or more incredibly, are we really to believe that buying this *junk* with money that the government doesn’t have will eventually turn a profit for the taxpayer! And perhaps most offensive to free market advocates is the questionable idea of bailing out banks at great national expense and then putting our hopes for regeneration in the very cast of characters that brought us this financial horror show in the first place! Are voters who suspect a little back-scratching really

the heartless and unpatriotic characters in this story?

Wouldn’t it make a lot more sense to encourage the private sector to get busy forming some brand new *Good Banks* led by some intelligent, unsullied managers? Surely there is plenty of private capital that would love to be invested in *good* residential mortgages and *good* auto loans unburdened by yesterday’s transgressions. And surely there is plenty of credible management talent among the hundreds of medium-sized banks in America that didn’t greedily participate in the packaging, mis-labeling and distribution of loans that everyone knew (or should have known) had no chance of being honored unless home prices kept rising at double digit rates. Count us as hopeful that a few good banks may rise from the ashes of what was for a long time a very good system. And, please, let’s retire the greedy old guard and the blind regulators while we’re at it.

However we do it, re-establishing a sound banking system is essential but it will not solve the whole problem. **First, the money lost in bad loans is, well, lost!** At some point, it has to be recognized (as the securities markets are attempting to do) that the nation, really the whole world, has suffered a “permanent impairment of capital”. A serious amount of our savings has been lent out and squandered on overpriced assets and will never be repaid.

*Second*, banks themselves only account for 20% to 30% of lending activity; 40 years ago that figure was more like 75%. The difference, in recent years, consisted of non-bank lending, primarily the distribution by investment banks (think Merrill, Lehman, Bear Sterns, Goldman Sachs, Morgan Stanley etc. etc.) of loan packages, especially “asset-backed securities; often these securities were backed by government guarantees to make them

marketable. This part of the credit transmission machinery (investment banking) has been devastated by defaults as far as the eye can see, and is in desperate need of a transparency overhaul... we'll watch for that; it will (must?) happen.

### **So when does it get better?**

It took a generation to build up this unmanageable pile of debt, and we won't get it under control in a year or two or even three. And as long as our government keeps adding to the total of unaffordable obligations there's no end in sight! This is not your father's business cycle; it's the last stage of life for a dysfunctional credit system, or more hopefully, the early stages of the reconstruction of a system of saving and investing we can believe in, built for a smaller reservoir of accumulated wealth than we had going into this decline. The unpleasant process is necessary and ultimately in our best interest, like radical surgery sometimes is; but life would have been a lot more fun if we had watched our diet and exercised more.

We're still a long way from even measuring the extent of our banks' bad debt problems, which is a key reason there are no credible solutions on the table yet (we're not convinced that nationalization is a credible solution). And it's not just banks that are represent serious risk; there are many more shoes to drop and more loss of confidence in the system yet to be suffered.

- Private and public pension plans are enormously under-funded following last year's drubbing;
- State and local governments have successfully solicited their first round of federal bailouts, but they will eventually have to deal with their out-of-control budgets;

- European banks seem in worse trouble than our own, with 20 years of massive loans to Eastern Europe where the wheels are coming off a fragile economy, and financial leverage that makes ours look conservative;
- Some Industrial companies, even great companies, have balance sheets that have become so leveraged that, in a credit starved environment, the very business is at risk.
- Insurance companies have had massive exposure to asset-backed securities and commercial as well as residential mortgages. Will AIG eventually be seen as the flagship of a whole industry in need of assistance?
- Counterparties have trillions of dollars of derivatives obligations; the risks in derivatives during an extended and volatile bear market are great, but the pockets are not nearly as deep as was once supposed.
- Healthy global trade is a sine qua non of modern economies; in turn, trade relies on orderly currency relationships. The current business contraction raises a serious possibility of protectionist legislation and a beggar-thy-neighbor currency devaluation spiral.
- A few issues back, we wrote about the infamous hyperinflation of the Weimar Republic. It originated in an effort to cope with an unmanageable national debt burden and a plan to give what we might call stimulus checks to non-working steel workers. 'Nuf said?
- And did we mention the old standbys...Medicare, Social Security and Medicaid? Or college loans? Or Fannie and Freddie?

So, there is an awful lot to deal with, and these are just in the financial realm (geopolitical tensions have been pushed off the front pages by scary financial stories and government proposals). Eventually we expect to behold the re-emergence of a transparent, market-responsive, intelligently regulated system for the productive use of private savings... savings which, by the way, are beginning to grow after a long, long drought. But we're not there yet and all the lobbying, posturing, and political promises of change and hope are only the opening chapter of what we expect will be a long reconstruction process. So, it's way too early to be talking about the next bull market for stocks.

But there will be rallies! Great, beautiful rallies, we suspect, if for no other reason than the fact that short-term momentum traders dominate stock market activity, and trading is a) responsive to news and b) self-reinforcing in the short run. All secular bear markets in the past have hosted temporary upswings of 30% and even 50%, on their way to historic low points. We can think of no reason to believe this secular bear market will be different in that regard. One great challenge confronting the investor is whether or how to participate in important market updrafts while maintaining an overall defensive posture during this possibly very long transition period.

### **Portfolio for the Transition Era**

So what message we can take away from this summary of the new investment context? **WHAT SHOULD OUR PORTFOLIOS LOOK LIKE?** Here are a few of the characteristics that seem appropriate to our effort to earn positive returns despite the grim setting.

- A lean equity exposure. Overall, stocks seem priced for an economic recovery within 6 months, which we think very

unlikely in light of the credit system repair that needs to happen. So our portfolios will not feature equities. However, there are at least three categories of equity opportunity we will be looking for: a) Innovation; new niches. These may emerge in any market environment. b) Market share gainers capable of top-line growth even in a stagnant or shrinking economy. c) Ridiculously beaten down stocks of good businesses that will make it into the next bull market.

- Investment-grade debt is a category where current yields promise equity-like returns even while positioning us higher (safer) in the capital structure than stocks.
- Short positions. While the stock market is overpriced, especially when we believe we understand *why* it is overpriced and what will likely develop to bring prices lower, it makes sense to make investments that will benefit from falling prices. We use Inverse funds that will rise in value when the corresponding index falls. We use actively managed "bear" funds that short individual stocks based on negative business fundamentals.
- Paired trades. One current example: we are short the 30-year treasury and at the same time long an investment grade bond fund to profit from what we believe is the inevitable narrowing of the unusually wide spread in yields between these two bond categories.
- Currency hedges. One of the potential abuses of government power likely to be on display in the present debt crisis is the regular devaluation of the currencies in which debts are denominated. This is a particularly great risk when, as now, no

important paper currencies are secured by convertibility into gold or any other standard that governments cannot manipulate. Gold Bullion is the obvious place of refuge for those seeking a non-corruptible store of value. We think accelerating demand will raise gold's price.

- As political and economic surprises of all sorts tend to dominate the headlines during periods of crisis, it is reasonable to expect continued stock price volatility. In such an unstable environment, frequent rebalancing is a low-risk strategy for adding value to a portfolio over time. We call it, "Making volatility your friend."

By incorporating these characteristics into client portfolios, it is our hope and intention to not only preserve capital in this chaotic transition period but earn a respectable return as well.

Finally, though we've seen an ominous 45% collapse in stocks just since we last wrote the Blue Sheets in November, and though it seems that nationalization of our major banks is a serious possibility, we remain optimistic that the majority of Americans understand and appreciate the value of our unique freedoms enough to resist the siren call of a nanny state. And we look forward to the peaceful resolution of the problem of too much debt, and to another wave of privately-financed innovation in the world economy.

*For the Investment Committee:*

J. Michael Martin, J.D., CFP

February 24, 2009

**DJIA** 7115    **S&P 500** 743    **NASDAQ** 1388    **30-yr Treasury** 3.5%