

Current Observations

FINANCIAL & INVESTMENT MANAGEMENT GROUP, LTD. • FEE-ONLY WEALTH MANAGEMENT

Waterboarding My Beliefs



by Paul Sutherland

I believe the world, at its core, is good. I believe that the universal values of courage, justice, humanity, temperance, transcendence and wisdom are common to everyone's intrinsic DNA. I believe we have more in common than we don't, but I also believe we see, hear and experience things very differently. There are lots of quotes about beliefs:

"Live your beliefs and you can turn the world around."

- Henry David Thoreau

"It's not the events of our lives that shape us, but our beliefs as to what those events mean."

- Anthony Robbins

"In religion and politics people's beliefs and convictions are in almost every case gotten at second-hand, and without examination, from authorities who have not themselves examined the questions at issue but have taken them at second-hand from others."

- Mark Twain

Some believe our world is melting down. They believe terrorism, war, poverty, greed, selfishness and indifference have caught up with us, and giant deficits, pollution, business failures, violence and other social and economic ills are their offspring. Clarity, reality and absolute empirical truth, no matter how sound their truthfulness, are subjective.

My beliefs have been challenged this past couple of months. What if oil goes to \$500 and the U.S. dollar continues to decline? What if all the banks fail, anarchy takes hold and terrorists seize an opportunity?

I know the importance of challenging my beliefs and how to mind-map complex problems, but what if the rating agencies that just reaffirmed our country's credit as AAA are wrong? What if the United States is more akin to Argentina or Rwanda than a real, honest-to-truth, rock solid, rich AAA country?

In the August 2008 issue of *Vanity Fair*, Christopher Hitchens wrote about a personal waterboarding torture experience. He recruited "extremely hardened veterans," who now train American soldiers on how to resist waterboarding, to conduct the procedure on him personally. His conclusion: "I would [have] quite readily supplied any answer."

Fortunately, I have not been waterboarded, but I do not think that even under such torture I would admit our world doesn't work anymore or suggest selling everything, and putting it in a tin can under a mattress. Perhaps I am hostage to my investment beliefs, but they come from education, experience, introspection, observation and scientific inquiry. Of course, they still must be challenged and questioned.

Some think economies are built on dreams, imagination and desire. That is true, but really economics is about life – living it, striving to better it and just getting up to earn a living. And I'd say that is true even if threatened by waterboarding.

So even under threat of waterboarding, what would I say my number-one portfolio worry is? It is the same as it has been for 24 years – that we do not exceed our clients' and shareholders' expectations. We have a good history of exceeding expectations over the last 24 years, not to say

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there have not been a few bumps. Actually, there have been *several* bumps, according to Barry Hyman, our historian (at least for this article), who looked to our internal statistics for the last seven years.

The statistics for the 2000-2003 FIM Group performance period are readily available and carefully reprinted below. They show the calendar year periods and subsequent year's rebound. They do not show the peak to trough periods and subsequent recovery, but we will be highlighting those numbers in our next newsletter.

Economic cycles, like the seasons or Earth's rotation, are not some quirky "invention" of

an economist. Economic and business cycles are rooted in our DNA – we humans move, we create, we work to eat, and we live a happy life and avoid suffering. The current unease over the investment climate, like Mr. Hitchens' waterboarding experience, will end. His ended with a simple hand signal to the veterans to stop and release him. Ours, maybe, will take more patience; for others, faith; and still for others, rational empirical scientific understanding. Regardless, we believe our portfolios are positioned correctly to perform. Meanwhile, we will continue to collect dividends and interest from good, solid investments. **F**

Portfolio	Annual Returns 2000	Annual Returns 2001	Annual Returns 2002	Annual Returns 2003
FIM Group Growth Composite	-10.32%	+26.12%	-9.09%	+42.01%
FIM Group Balanced Composite	-3.93%	+25.87%	-6.66%	34.65%
FIM Group Balanced Conservative Composite	+3.00%	+24.47	-3.72%	24.19%
FIM Group Yield Income Composite	+7.26%	+23.08%	+0.06%	+20.54%

** See page 6 for disclosure*

*For clients that want to drill down on our statistics, the enclosed **Perspectives on Performance** shows FIM Group performance data to 1998.*

Beauty and the Beast



by Suzanne Stepan

Volatile markets, like those we are currently experiencing, can be beastly for the typical investor. Emotions trump reason, and stock and bond positions are liquidated with a “sell now, ask questions later” mindset. Cash becomes king, and any pledge to follow a long-term investment horizon is thrown out the window. Losses are locked in and made permanent while, in many cases, subsequent entry back into stocks and bonds will only occur long after things have normalized (and, of course, become much more expensive).

For FIM Group, on the contrary, volatile markets have a much more underappreciated beauty. Stocks and bonds sold by the masses at distressed prices become the seeds for our long-term portfolio returns. Our advantages are

a sufficient time horizon and the ability to sift through market fear and decisively buy when stocks and bonds are offered at the kinds of terrific bargains we are seeing today.

Einstein said, *“All the problems we have in the world today were generated by one type of thinking, and you do not solve those problems by using the same type of thinking.”*

One rather controversial area where we see tremendous bargains is that of financials. Financial sector share prices, as shown in the chart below, have been decimated to levels not seen in nearly six years. Our team has been bargain shopping in the midst of this selloff, and one area of particular focus has been the preferred stocks of a broad range of domestic financial firms.

IXM Index

The index includes financial services firms who business' range from investment management to commercial and business banking.



Source: Bloomberg

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Preferred stocks pay a fixed dividend and have a claim to the assets of a corporation ahead of common stockholders in event of liquidation. Our strategy with these preferred stocks is to avoid concentrating on any one firm, and instead build a basket of positions that we judge to be selling considerably below fair value. We look beyond simply the allure of double-digit dividend yields and focus on positions we believe to be sufficiently capitalized to weather the current financial sector storm. Purchases are made only when we expect to generate a minimum total return (dividends and capital appreciation) of 30% over a two-year time horizon. While there is the possibility that the economy may slow down even further from its current state, the market has seemingly priced in an apocalyptic catastrophe for these preferred securities. We acknowledge that a second round of capital raising and dilutive risks exists, but these possibilities appear to be more than sufficiently pre-priced into the preferred basket we have assembled.

The basket approach of owning preferred stocks should yield sufficient total return even in the extreme case that 10% of its constituents go to zero. As mentioned above, we target a minimum two-year total return of 30% for each of the preferred stocks in our basket. Even if 10% of the basket gets clobbered and plummets completely (total loss), our basket is expected to still make a respectable 17% total return. Rest assured, our FIM Group team is not betting the farm on these preferred securities to outperform. We are incorporating the basket approach as only one component of our overall portfolios, where we have plenty of non-financial exposure.

In addition to limiting issuer risk by diversifying company exposures, our preferred stock basket is also diversified among financial services sub-sectors. Our holdings of insurers, banks, agencies and REITs (real estate investment trusts) each face different degrees of exposure to

write-downs and capital adequacy issues. Market participants have not sorted through the details and in turn have chosen to indiscriminately lump them all together into a big clump of fear that has driven prices to unprecedented levels. It is our belief that both the insurers and the REITs for the securities that make up our basket are more than adequately capitalized, while the banks' and agencies' pricing has already been discounted for significant future capital raises.

Our team views each of our preferred holdings as longer-term investments with the possibility of significant short-term volatility. Because of this, we have compensated in some of our strategies by trimming other securities to keep overall expected portfolio volatility within acceptable parameters. In these cases, we sell those investments we view to be equally as volatile but with less total return potential to the preferred basket.

Market volatility can be quite beastly, and that has certainly been witnessed in the stocks and bonds of the financial sector. Our team sees underappreciated beauty in financial sector preferred stocks, and we are not afraid to take advantage of bargain sale prices as others try to perfectly time a bottom. We have been around long enough to know that such timing is rarely achieved, and that when the market offers prices at deep discounts, you better seize them because they rarely last. F

Investment Team Briefs (July 30, 2008)



by Zach Liggett

Item: Consumer discretionary stocks haven't been this hated in a long time. This sector's weighting in the overall market continues to hit long-term lows (see chart below).

FIM Group Response: Investor preference for consumer discretionary stocks – a broad segment including retail, media, home builders, automakers and restaurants – has been on the decline for much of the last 15 years. Investors have instead flocked to the hot sectors du jour (technological, financial and most recently energy). With all current signs pointing to more stress for the U.S. consumer ahead, it's difficult to get too fired up about this obviously neglected part of the market. But when viewed on a longer-term perspective, and with a good dose of contrarian conviction, well-managed companies in such disfavored sectors deserve a closer look. We are naturally attracted to sector charts like this as a starting point to hunt for stocks with potential to provide great long-term total returns. Consumer discretionary stocks we are beginning to buy for some of our strategies that we believe offer very compelling value include: Viacom, *Washington Post*, Leggett and Platt, Newell Rubbermaid, News Corp and Interactive Corp.

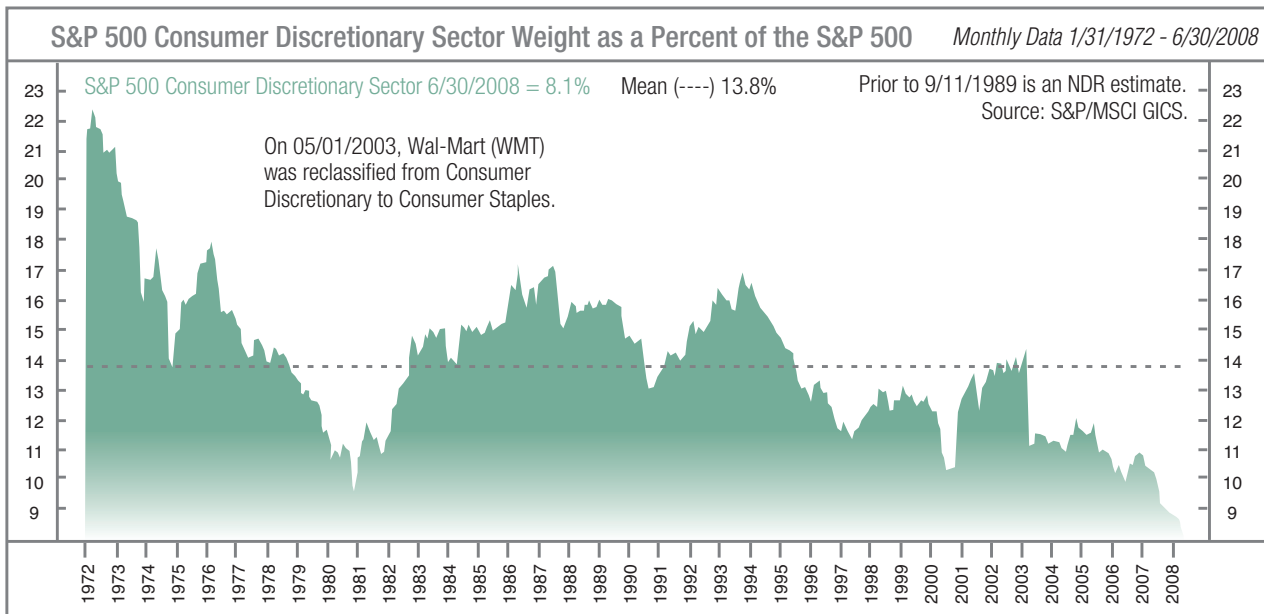


Chart Source: Ned Davis Research

FIM News

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In July we were happy to introduce our new website, *www.fimg.net*. Now you are able to see our most recent webcasts discussing various market issues, along with up-to-date news for FIM Group. We will continue to make updates to the site, so be sure to check back.

Want to go paperless for your FIM Group statements? We would be happy to assist you in setting up your account online. Please contact Client Services at *231.929.4500*.

The Quiz

What year in the United States were the first issues of preferred stock offered?

- A. 1836
- B. 1945
- C. 1902
- D. 1975

Answer online at fimgquiz.com to be eligible for a monthly prize. You can also call 1.800.632.5528.

Disclosure

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