

Current Observations

Sleeping Like a Baby

By Paul Sutherland, CFP®

Lately I have been sleeping like a baby – asleep for an hour ... and awake for an hour. We have a toddler, and he seems determined to make sure my wife and I get a “less than restful” night’s sleep. So lying awake at night what do I think about? The financial markets, investments and FIM Group portfolios, of course. What follows are some of the issues (both large and small) that I think about, but I realize that every worry is also an opportunity. For example, we think that housing, retail and the U.S. banking industries will have a very tough few years – so the opportunity is *simply don’t invest in those sectors!* Similarly, we see significant forces around the tangled, complicated fight of the weakening U.S. dollar, deflation and inflation, and thus see significant opportunities to grow and preserve wealth by investing appropriately based on our analysis of how we see those forces playing out. So here are some of the key long-term trends we are watching.

America’s Relevance

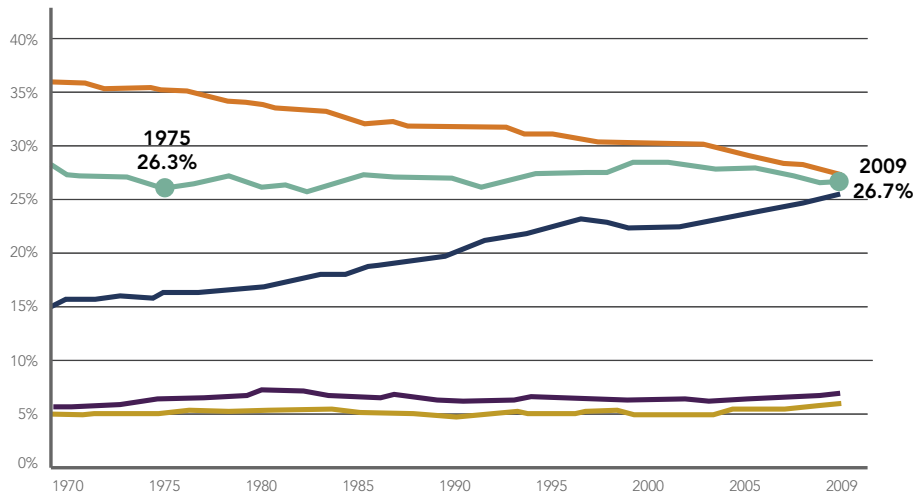
FIM Group has always been about investing globally, so it is nothing new for our clients to hear about the robust opportunities that exist all over the world. In some ways I think that the world is realizing that the good ‘ole USA is not as necessary to their security, safety, well-being and economic prosperity as it once was. There is a new generation globally, and they have little patience for the stories told by their old folks of how the U.S. helped in their country’s development. I think the U.S. got lazy. Now after many years of benign neglect our political clout, through an unfocused and politicized myopic foreign policy, especially around economic issues, has helped us lose some of our relevance in the world. In addition, the world (especially Asia) has simply grown. What is heartening to me as a proud American is that as a percent of the world’s big, fat economy of around \$60 trillion, the U.S.’s share has been pretty constant (see GDP chart on page 2). Europe has been the bigger GDP loser, and while Africa and Latin America have had benign growth, Asia has been where the big change has taken place. Asia is coming into its own, saying, “Hey, we are relevant, we are strong and we can sit at the table of the world’s richest nations because we earned it!” Like a teenager that forgets all the help and guidance of the parents, Asia (as will other countries as they develop) will wish to cut the umbilical cord to the West and with national



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Share of World GDP

1969-2009



SOURCE : ECONOMIC RESEARCH SERVICE OF THE U.S. DEPARTMENT OF AGRICULTURE



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pride be indifferent to those who helped them along. The talk show hosts that got mad at France, chatting of boycotts and changing the name of “French fries” a few years ago for differing with us on our foreign policy, are a good illustration of this. The U.S. exists because the French helped us kick the English out. It’s that simple! Most of Asia exists because 60 years ago we helped China and other Asian countries defeat Japan’s armies.

About 16 years ago I was on a rickety boat off the coast of Mersing, Malaysia. An older man who was navigating among the fishing vessels in our small boat heard my American accent and said, “Oh, you’re an American! Thank you! I vowed to always say thank you to every American I meet for all the help you gave our country.” I am a proud American because of encounters like that. However, in the world we see today, our military influence has much less clout in today’s world where economics rules. The free world today gets a free ride on America helping to police the world, and just as Rome, England and the warrior Kings of Africa learned, military might does not tend to evolve or help maintain economic might. Healthy countries

want to take care of their own security needs; naturally they will take our help for free, even if they don’t need it. The economic drag of America’s war machine, the conflicts in which we are engaging, our aging population ... all these things will contribute to the fact that big opportunities for our wealth is overseas, in countries with lower taxes, younger work forces and lots of room for development.

I hope that my comments will not make readers feel worried, sad or even angry. They are not intended to be political, and they should not be taken as a statement of my personal political opinion. The U.S. needs a strong defense, because the world is an unsafe, scary place. There are plenty of people who would like to see the West destroyed. Fortunately we can afford to have a giant military that costs more than all other defense spending in the world combined. But, unfortunately the cost is growth, our clout in the world, higher taxes and our brave men and women fighting in Afghanistan and Iraq.

We Are Rich!

According to the UN News Centre, America has around \$144,000 in wealth per capita vs. the global average of

\$20,000 average and just \$1,100 in India (data based on the year 2000). Both the U.S. and the world’s wealth have grown since then, but we still are the richest country per capita.

America is so rich that even though we have some erosion effect from our burgeoning government spending and aging population, we will always be rich. We work hard, believe in education, solve problems and learn from our mistakes. Right now we are finding our place in the world with wars, a new president, special interests and a plethora of other issues. It is natural that our foreign policy will be centered on the handful of countries with whom we are fighting. Meanwhile, China, Europe and others have policies that nurture relationships with resource-rich nations, and the buyers of their goods and services ensure their future growth. Bottom-line growth in America will be slower than elsewhere.

Invest Slow or Fast? Easy Choice

Investors are silly folks. They are collectively stubborn. Because of endowment behavior most investors will stay with an investment even if they expect it to under perform, because their brains are wired to do so. Many investors will naïvely invest in benchmarked or indexed portfolios of mainly U.S. stocks or bonds even though they know that many areas of our economy, such as real estate, retail and banking, have crummy prospects. They will stay in U.S. bank CDs even though they believe the U.S. dollar is destined to continue to erode in purchasing power and inflation is most likely around the corner.

It is rational to have a diversified portfolio, and we are believers in diversification. With more than 50,000 stocks and millions of bonds to invest in, an investor would be either silly or lazy to choose investments that they know have poor prospects going forward, like U.S. banks and real estate. So sometimes when I am lying awake in bed, I reflect on our investment year and ask, “What am I missing?” It seems so rational that there will be – although lumpy – growth in energy,

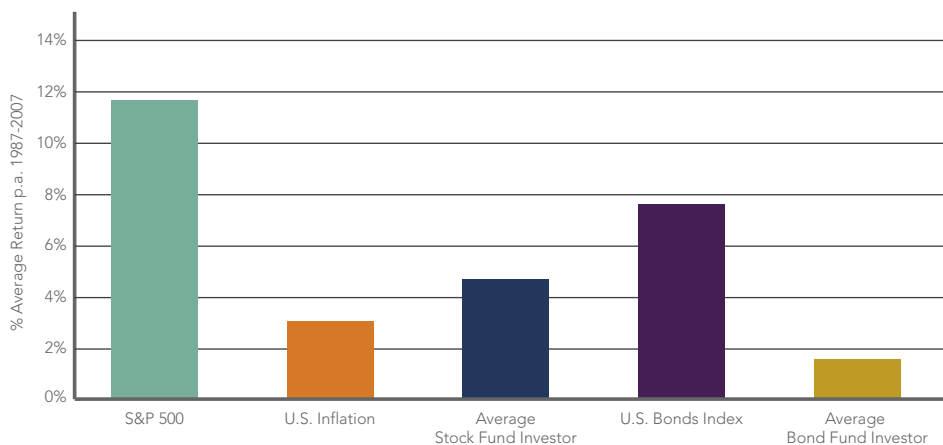
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food, agriculture, health care, telecommunications and emerging countries, and that inflation with pockets of deflation is most likely in our future. Therefore, those are the themes that are well-represented in our diversified portfolios.

Retired and Portfolio-Dependent Clients

Many of our clients are retired and dependent on their portfolios for income now and in the future. That future might be the next 40 years or next month. I can tell you with certainty that the future will have inflation, deflation, recessions, corporate scandals, Wall Street greed, war, booms and changes in tax laws, high interest rates and low interest rates. Dividends will be taxed a little, and they will be taxed a lot. I can tell you that thousands of books and tens of thousands of articles will be written stating the absolute best way to invest. I also can tell you that most investors will fail to meet their goals, because they fail to have a common-sense long-term view, and clear goals and objectives of what they expect from their portfolios. At FIM Group we are guided by a common-sense philosophy and fiduciary duty, and each portfolio has goals and objectives that are built into their construction and management. Investors not guided by goals and a long-term view often panic in crashes and are seduced by slick salespeople and logical-sounding strategies (note the Dalbar chart on the right). Lying in bed, in my head, I go over each portfolio's position. I ask myself, "What if we have hyperinflation, another crash or a super-strong economy?" Or, "What if rates stay near 0% for money markets, CDs and other so-called 'safe' investments?" CDs and the like don't give inflation protection, nor do they protect against U.S. dollar weakness or an eroding currency environment. I scenario out the possible futures and "stress test," so to speak, our portfolios against each scenario. Then I fall asleep, hopefully without a 5 a.m. "Daddy!" coming from Patrick's room.

Investor Returns Do NOT Match Market Returns



SOURCE : DALBAR INC., UBS WMN

FAQs:

Speculating, Investing or Are Results Simply Random?

By Barry Hyman, MBA



Q: Are my portfolios positioned to handle inflation? If not, how do we ensure that they are?

A: Inflation is a double-edged sword – as it increases the cost of much of what we spend money on, it also erodes the purchasing power of the money we have that is not growing at least as fast as inflation. Inflation also pushes up the values of certain (inflation-sensitive) assets we own, such as homes, art, precious metals and stocks in companies that benefit from inflation. During inflationary periods, savings left in cash or supposedly "riskless" investments that earn rates below that of inflation (e.g., CDs, savings accounts, T-bills, fixed annuities, etc.) lose purchasing value. FIM Group believes that the stimulus actions of global governments will cause increased inflation. Therefore, we have built our portfolios to own securities that we believe with benefit from, or at least exceed the rate of inflation, including those of gold, precious metals, commodity-producing companies, mining companies, food companies, energy companies, and pharmaceutical and medical technology companies.

Q: What is the impact of the U.S. dollar dropping in value, and how do we protect against it?

A: In addition to inflation, another result we anticipate from the stimulus actions of our government, namely extremely low interest rates and massive borrowing/spending, is downward pressure on the U.S. dollar. This phenomenon also has dual outcomes. A devalued U.S. dollar makes domestic goods and services less expensive to countries with stronger currencies, which should make American businesses more competitive globally and thus stimulate our economy. But for consumers at home, it means that nearly everything we buy will become more expensive due both directly to increasing costs of foreign products/labor and indirectly to increasing prices of purely domestic competing goods and services. Foreign-denominated assets, such as foreign-listed stocks and bonds, directly increase in dollar terms as the dollar falls. FIM Group, however, does not invest in foreign investments merely because we are predicting the direction of currencies. As a matter of fact, we require a higher margin of safety in the prices of the foreign

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investments we buy specifically because of the added risks currency fluctuations may present. We currently invest in foreign economies and companies that we feel are poised to benefit from local, global and company-specific factors, resulting in our portfolios benefiting from a weakening dollar.

Q: Are my portfolios positioned to endure another economic downturn? If not, how do we ensure that they are?

A: We are long-term investors, not market-timers. We look for long-term bargains and do not try to time the markets. We must allow for our portfolios to fall during downturns in order fully participate in the long-term benefits of our investment management. Because of market cycle fluctuations, the money we manage should be viewed as long-term money. As for retired clients who take income from their portfolios, they need to understand our goal is long-term growth of income, not short-term market timing. That said, a normal by-product of favoring investments with higher-than-average dividends, cash flow, balance sheets and price-to-value fundamentals in normal market downturns generally provides a downside cushion.

Q: The financial industry has convinced many investors that “markets are efficient,” “you can’t beat the market” and several other “truths,” so why should an investor pay fees for active management?

A: It is indeed true that 80% of the so-called money managers (actually mutual fund managers are the universe used in such studies) under perform the average (i.e., the market indexes). But that does not mean markets are efficient. Nor does it mean that the approaches used by the mediocre managers are anything but mediocre. Mediocrity, plus mutual fund constraints, minus fees equals lackluster performance. No argument here. But what about the other 20%? Using this theory implies that on any Sunday every football team has the same odds of winning as every other team. It implies that Tiger Woods, Roger Federer or the New York Yankees have the same probability of finishing in the top half of the pack as the bottom. The fallacy in this logic seems obvious to most people when talking about sports or other fields, yet some still believe that investment success is random. Tiger, Roger and Mr. Steinbrenner all have systematic competitive advantages. So do investment managers who employ time-tested techniques and skills such as favoring securities with the qualities

mentioned above and avoiding securities that are either overpriced or have headwinds to overcome. Yes, Tiger misses the cut sometimes. Yes, managers with solid long-term performance have periods where they under perform some arbitrary index. But in the long run, time-tested disciplines provide better returns with less downside risk (on average!) than random investing. In the case of FIM Group, we missed the cut in 2008. But we have regained ground lost to most arbitrary benchmarks (such as the S&P 500) in 2009. Nevertheless, one year versus another is not what counts. What counts are long-term results. For readers who have not been with us for more than ten years, I encourage you to ask your FIM Group adviser to show you our ten-year returns for periods ending September 30, 2009, or ten-year periods ending 2008, 2007, 2006, etc. Past performance notwithstanding, we remain forward-focused. We manage in the present, employing the timely strategies such as those described above. But we remain flexible, with our ears to the ground, and willing to change course as conditions warrant.

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