

Current Observations

Just Say 'Yes'

By Paul Sutherland, CFP®

Last month's *Current Observations* newsletter was mainly about getting through the investment territory, and I ended my article promising to discuss FIM Group's plans to prosper and successfully be invested through the new economic reality. I also ended my article with a quote by Charles Darwin about how success does not necessarily result from being the fastest or strongest, but rather the most flexible. Taking Darwin's thoughts into account, this month's newsletter will cover several topics: First, we will summarize our thoughts on what the future holds; second, we will examine specific investments and explain why we favor them; and third, we will further review some of the lessons we've learned from this past year.

We see politics playing an increasingly identifiable role in capital flows going forward. But this is not just about President Obama – all governments have an effect on investing. We believe that the government's influence on investing over the next few years has already been pretty much spelled out for us, but we are global investors, so we tend to look at our own country's political economic inputs as just one of many. Putting political biases aside we assume that others will support the process of getting back on our feet, fixing our problems and moving forward. The world is significantly different today and continues to change, but as investors we cannot let our political views guide our investments.

In the U.S. we'll see inflation, slow overall growth and low interest rates for quite some time. There is much thought and debate whether we will experience a quick "V-shaped" recovery or a dramatic recessionary downturn, resulting more in a "W-shaped" recovery. With the bulk of the economy's credit problems still to come, we see the economy more like a big "L" without a recovery of consequence, but as long-term investors we think it is folly to devote much time to the V-, W- or L-shaped debate. In the foreseeable future, the U.S. economy is going to be in "slow-growth" mode dragged down by numerous "expenses" like treasury debt, war/defense, health care, real estate oversupply, banking weakness, and hesitant consumer spending. All this evidence leads to one political and societal conclusion: Just say "yes" to everything.



“A democracy will continue to exist up until the time that voters discover that they can vote themselves generous gifts from the public treasury.”

– Professor Alexander Fraser Tyler (1797)

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In *Democracy in America* (1835), Alexis de Tocqueville said,

“The American Republic will endure until the day Congress discovers that it can bribe the public with the public’s money.”

Professor Alexander Fraser Tyler (1797) placed more responsibility on the citizens in his analysis of a democracy, “A democracy will continue to exist up until the time that voters discover that they can vote themselves generous gifts from the public treasury.” Could this be our modern-day “bailout”?

We are not trying to be pessimistic in this newsletter; rather, we are quite optimistic about America’s future. But we are realistic about the economic issues. The government has made significant compromises that have affected a stable and successful democratic political system. They also have adopted a “just say yes” political climate that can only have result in the economic conclusion of inflation. Ten years ago Alan Greenspan warned that there might be a \$5 trillion surplus under a rosy scenario and mused that we might also have a Treasury bill shortage. Today, we have an \$11.5 trillion deficit, which has increased \$3.99 billion per day since September 28, 2007. It is rational to assume that politically, at least, we will turn the printing press on in order to print and borrow money. Of course we will continue to say “yes” to things that are no longer useful. And a simple conclusion from the economic fact set today is that seasoned, experienced global investors will have an edge. So we are optimistic about our future and the future of our portfolios.

There are some positives to the universal “yes” that will be the hallmark of Washington. Health care paid by all taxpayers may allow manufacturers to be more competitive. It could also be good for pharmaceutical companies.

A weakened U.S. currency resulting from deficit spending can help our exporters. Since manufactured goods are mostly value added despite the fact that commodities will cost more due to our inflation, we will have a competing balance to help our manufacturers at least a bit on the competitive front. However, we will conclude that the real positive economic action will be in the developing democratically oriented open countries of Asia, Africa, Eastern Europe, and South and Central America. We subsidize the world with our spending and our demand for materials even if we need to borrow or print new money to buy it. There will be economic areas that shine, and the U.S.’s dominant position will not subside. It appears, though, that more and more U.S. companies’ profits will not go to its investors, but rather to taxes, inflation and inefficiencies caused by well-meaning bureaucratic solutions. Congress generally does one of two things when confronted with a problem: nothing or overreacts. Currently, we are overreacting to a multitude of issues, the aftermath of doing nothing then reacting to September 11th, a health care crisis, an energy grid built during the Great Depression and antique financial regulations.

During this renaissance period of “just say yes,” FIM Group will concentrate our investments in well-managed, dividend-paying companies with good balance sheets and that conduct business either in industries we favor or areas of the world we think have great growth prospects. We like energy, telecommunications, health care, agriculture, infrastructure and companies in industries that should benefit from inflation. And because we have built our careers on paying the right price for investments and owning the right companies, we do not

oversimplify or use asset allocation or indexing as anything other than a tool.

I find that today many professional investors will promote indexing-oriented asset allocation as their primary investment strategies, because they don’t want to deal with the big picture of price or where to invest. They just say *be everywhere*, which, in a dynamic world of creative destruction, is a loser’s game.

Why would you passively invest in industries that are about the past and not the future?

Circling back to the “L-shaped” economy and its influence on our investing, it’s fair to say that most readers know by now what we will say: collect dividends and invest in “gotta-have” industries like food, health care, energy and communications; favor investments that have solid balance sheets that can survive and thrive in a slow economy; and, of course, invest in globally thinking and acting companies, or companies in good niche businesses.

In last month’s *Current Observations*, we reviewed what we learned from this past year’s economic malaise. And now, thinking in terms of a “realistic worldview,” we would like to add one new thought, though it is not really “new,” because Jeff Lokken mentioned it in his tribute to Warren Buffett a few months ago. If your worldview involves a hopeless, pessimistic and depressed future where democracies don’t work and capitalism cannot be on balance with and sensitive to society’s needs, then we are not the investment managers for you. We try hard to give you our “real” worldview. We don’t say what we think our clients want to hear. We don’t believe in Pollyanna or obsequious-guided prose to attract clients. Rather, we believe in transparency and honesty and explaining what we do and why we do it in clear, concise terms. We are not perfect, as last year proved, but our 25-year history and 2009 performance to date illustrates that we are pretty good at what we do.

Investing 101

In two of FIM Group’s newsletters this past year, we relayed findings from the market research company DALBAR, Inc., that we found to be interesting: over a 20-year period the average investor in stock funds earned significantly less than the funds themselves. This paradox is the result of investors’ emotional behavior, including selling out of fear and not getting invested again until after stock prices have recovered much of their declines. The most recent market cycle, which hit its nadir on March 9, 2009, was a textbook case study in what might be called “the overwound spring effect.”

During normal times, the “spring” of the market – the tension between volatility and return (risk and reward) – is *modestly wound* to a state of equilibrium. In this state, prices fluctuate and investors are rewarded somewhat proportionally to the amount of prudent risk they accept. When left invested over the long term (multiple decades) the portion of investors’ assets in stocks, as measured by the S&P 500 or Dow Jones Industrial Average, has averaged a total return, including dividends and capital appreciation, of a little under 10% a year [source: Ned Davis Research]. To

achieve those favorable returns (relative to inflation or riskless investments), investors had to be patient through normal market price fluctuations.

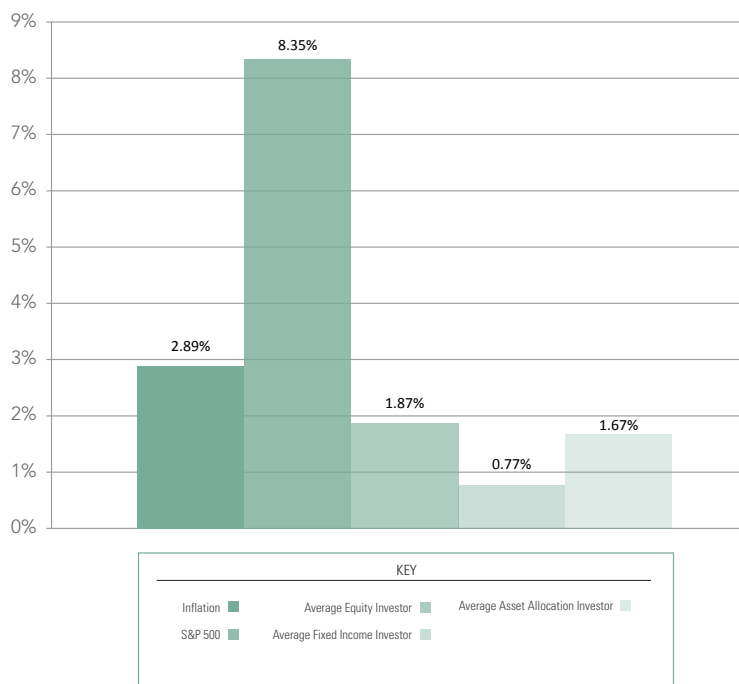
Under less common periods of mass hysteria, whether it’s manic buying, when “everyone is making money in the markets,” or panic selling, when “no one knows how low it will go,” investor sentiment reaches extremes. Those extremes have an effect on the relationship between investment prices and their intrinsic values similar to that of a spring wound well past the point of equilibrium. Just as it is difficult to hold on to an overwound spring for more than a brief period, the markets are not able to hold security prices to extremely overvalued or undervalued states for very long. What happens next in investment markets is often similar to the spring when the holder can no longer keep it compressed – *it snaps back with ferocity*.

For examples of extreme *overvalued* states, think oil in mid-2008, tech stocks in the late 1990s, Japan stock and real estate prices in the late 1980s or precious metals in the early 1980s. In every case, the ensuing unwinding of overvalued prices was not

In a nutshell, here is a painfully short recap of what happened:

- The U.S. government deregulated banks and encouraged aggressive lending, spawning massive mortgage securitization
- Some large banks and insurers made heavily leveraged speculative investments in mortgage securities
- A couple major banks (Bear Stearns and Lehman) collapsed
- The market for mortgage securities dried up
- The U.S. government imposed excessively harsh accounting rules on valuation of mortgage securities, decimating institutions’ balance sheets
- Lending markets reacted by making credit unavailable to corporations
- Institutions in need of cash, liquidity, money or reserves had to sell everything that was not nailed down (e.g., common stocks, bonds, preferred stocks)
- The U.S. government overreacted and frightened the public
- The public panicked and sold, along with corporations, pensions, etc.

AVERAGE RETURNS FROM 1989-2008



RESULT

Self-feeding downward spiral in prices of nearly all securities . . . creating the best bargain prices in generations.

Examples of “overwound spring” bargains that have resulted from the panic:

- P/E ratios of many stocks below 10
- Dividend yields of many stocks above 5%
- Prices of some stocks below tangible book values
- Prices of some stocks (hundreds globally [source: Bloomberg]) below net cash on those companies’ balance sheets

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pleasant for those holding assets at such levels. Thus the reason FIM Group feels it is imprudent to “buy and hold at any price.”

For examples of extreme *undervalued* states, we can look at U.S. stocks in 1982 (when price-to-earnings multiples had fallen to below 10 after 16 years of disappointing returns [source: Crestmont Research]), “junk” bonds in 1991 (after their prices had fallen and yields had risen to more than 20% [source: Ned Davis Research] in the wake of Milken, Boesky, et al), Asian stocks in 1998 (after the Asian economic crisis decimated prices), Hawaii real estate in 1998 (after an economic collapse in Japan and the rest of Asia depressed Hawaii’s economy), resort prices in 2001 (after the attacks of 9/11 made markets react as though no one would ever board an airplane again), oil in early 2009 (after it had swung from \$147/barrel to under \$40/barrel [source: Bloomberg]), and finally, the point of this article, many “value stocks” in the spring of 2009 after “the panic of 2008.”

Many great value-oriented managers with multi-decade records of superb risk-averse market-beating performance (like Warren

Buffett, Marty Whitman, Mason Hawkins, Bill Miller and Chuck Royce) had declines that approached 50%, 60% and even 70%. Being disciplined investors (as opposed to speculators or market timers), all of these proven opportunistic value managers, of which FIM Group is a member, did not sell just because everyone else did. Rather, the discipline we all followed was to resist fear, hold our noses and take advantage of the bargains created by these opportunities. Beginning in the spring of 2009, when these over-tightened springs of opportunity were finally released, returns of all the aforementioned managers exceeded the returns of the major market indices.

It is imperative for investors to understand that the first half of each “bull” (rising or recovering) market has historically been when the bulk of the market’s returns have been achieved. The data that supports this ferocious snapback tendency is very compelling. Since 1929, subsequent to each “bear” (declining) market, the Dow Jones Industrial Average gains in the first half of the ensuing “bull” markets have averaged 43.5%, whereas its gains in the second half of each bull market have averaged only 16.8% (source: Bloomberg). In other words, a major risk to investors trying to time the market is not being invested at

the bottom. Next time the thought that “it’s different this time” washes over you, remember these very important guiding truths: 1) It’s different every time in some way; 2) People often repeat their behavior; and 3) While they may inherit the world someday, it is during times like these that wealth often transfers from the meek to the emotionally prepared.

For specific information regarding performance on specific FIM Group holdings or the accounts in your portfolio, contact your FIM Group adviser.

“The average man doesn’t wish to be told that it is a bull or a bear market. What he desires is to be told specifically which particular stock to buy or sell. He wants to get something for nothing. He does not wish to work. He doesn’t even wish to have to think.”

– Jesse L. Livermore

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