June 8, 2010

Dear FIM Group Clients,

Investors were skittish (to say the least) in May. Understandably, though, people throughout the world are suffering from "post-traumatic investment syndrome" and have itchy trigger fingers after enduring "The Great Recession" and its effects on asset prices. The month of May brought multiple global events that gave nervous investors even more (perceived) reasons to throw logic out the window, hit the panic button and "just sell!" Debt problems in Greece and other European countries, a criminal investigation of BP and what appeared to be mixed economic signals in the U.S. all came to a head in May, causing some pundits to say that we are headed for a second round of malaise-caused indiscriminate selling. Global stock markets also gave back several months of gains, the S&P 500 fell 8%, the EAFE Index – a broad measure of International stocks – fell more than 11% and the Stoxx Euro 50 – an index of European stock markets – declined more than 12% in U.S. dollar terms. As you will see in the enclosed report, FIM Group's holdings were not isolated from the volatility.

In a true sign of emotional selling, virtually all stock markets in all countries fell regardless of the weight of ALL the evidence. This is classic "groupthink" behavior (actually, it's more like "groupfollow" behavior). Similar to buying manias (e.g., real estate, tech stocks, gold, etc.) during panic (selling) episodes, so-called "investors" make the emotional decision to "just sell" everything. Their intention is to avoid further pain and hopefully get back in later, despite being reminded repeatedly that they cannot time the markets. It is precisely this behavior that creates bargains and opportunities for "real" investors.

Here is a summary of some of the evidence the sellers and pessimists are ignoring. First, stock prices. Using the U.S. stock market as a proxy, even after rising significantly from the March 2009 lows, valuations are at historically low levels, with the S&P 500 selling at only 13 times 2010 estimated earnings (and given where we are in the cycle, it is likely that the earnings estimates are still too low). The historic average market PE has been above 16 over the past 100 years (Source: Bloomberg). Price/Book, Price/Sales and Price/Earnings ratios are all below historic averages (Source: Bloomberg). Such ratios imply that the economy is weakening. But is it?

The weakest link in the U.S. economy is jobs. Employment is the last sector of the economy to recover after a recession. Jobs have indeed been added every single month this year, but not as quickly as following previous recessions. This is not a sign that employers are not confident. Rather, it is a sign that U.S. business has transformed since previous recessions. Due to advances in technology and business efficiency, businesses do not need to build up inventory at nearly the rate they had to in the past. That said, in addition to slowly adding new jobs, the average weekly hours of the existing work force is increasing. The increase of hours worked in May was equivalent to adding 315,000 new jobs. Average weekly earnings of people with jobs increased 0.6% in May and have increased at a 5.3% annual rate over the past three months. Yet at its current average of 34 hours a week, the existing work force is not at full capacity, so it is reasonable that the rate new jobs will be added is going to be slow.

Based on how strong the rest of the economy has been, new jobs will be added to our economy slowly and will be seasonally lumpy. Not only are hours worked and hourly pay up, both the manufacturing and non-manufacturing sectors of the economy are growing robustly. Despite the turmoil in Europe, the ISM (Institute for Supply Management) non-manufacturing index is above 55 (anything above 50 indicates economic growth), the highest level in nearly four years; the business activity index is at 61, has risen for four months in a row and is at levels consistent with strong economic growth; the ISM manufacturing index is at 59.7; the new orders index is it 65.7; the production index is at 66.6 – all of these levels indicate very strong economic growth (Source: First Trust Advisors). Interesting that the press and the pundits seem to ignore these facts and instead prey on bad news and fear.

The turmoil in Greece and the rest of Europe has been a major impetus to the selling pressure on stocks. Yet, taking a historic perspective, what is going on in Europe is really just business as usual. Countries

have had economic crises since time immortal. Just in the past 20 years we have had crises in Mexico, Argentina, Asia and, most recently, the mature economies of the U.S. and developed Europe. Greece, Spain, Italy and Portugal are just now facing what many of their larger neighbors faced over the past few years. Relative to other crises, those of these small European nations are not very significant to global commerce.

The falling Euro is another hot button. It has caused not only stocks to fall, but the U.S. dollar to rise, a double whammy on the U.S. dollar-based price of foreign securities. But is this rational? The Euro has ranged from about $1.20 at its inception 11 years ago to a low in the $0.80s in 2000-2001 to a high of $1.60 in 2008. Currency fluctuations are normal. A falling currency is normal as an economy slows and interest rates decline. The fall of the Euro is warranted, but the rise of the dollar is not. People are flocking to the dollar just as they do to gold or money in the mattress during brief periods of fear. But once the fear subsides, it would be normal for the dollar to resume its decline, a reflection of the high debt and mature state of the U.S. economy. When that happens, it will favor foreign-denominated holdings.

Are the U.S. and Europe heading for a redux of “The Great Recession” of 2008? That is indeed what the pessimists are afraid of. At FIM Group, however, we feel that this fear is absolutely unfounded. What caused that crash was a combination of overly easy credit fueling real estate speculation, massive debt/leverage taken on buy the banking system, followed by draconian measures taken by regulators (namely mark-to-market accounting that was finally repealed in early 2009), all of which caused a credit crisis of historic magnitude. Real estate speculation is over, so are “liar loans” and other forms of easy money. People are paying down rather than taking on more debt. Most important of all, it is clear from the actions of the U.S. and global leaders that governments will pull out all the stops to keep financial markets functioning. The U.S. government committed a few trillion dollars to our system. The European Central Bank and the International Monetary Fund have committed a trillion dollars to their crisis so far, and there is a lot more available. Of course the downside to such back-stopping is the headwind debt blow against future economic growth. But slow growth is the inevitable cost of overindulgence whether the debt is in the banking system, the consumer, corporations or the taxpayers. Nonetheless, to put these amounts in perspective, the output of the U.S. is $150 trillion per year, and once again the press and pundits fail to put things into perspective.

The bottom line is that we are indeed in a state of investor fear. But we feel, and history has proven, that a fearful climate warrants a buying opportunity rather than a selling one. The decline in portfolios is no fun, but it is part of the process. The only way to take advantage of the bargains available is to withstand the volatility in times like this. We are not suggesting buying and holding passively. We have indeed sold several holdings that have either reached the point at which the expected future returns do not warrant the potential downside, or whose fundamentals have eroded (like BP). But we are also actively taking advantage of the opportunities being created. People will still eat, wish to maintain their health, want to drive, will heat and cool their homes, and will phone up their dad to say, “Happy Father’s Day!” Governments will overpromise and citizens will demand more, and the natural tensions of economic “progress” will continue, where capital, labor, business, government and institutions compete and cooperate to further their goals. In other words … life will go on.

We are confident that when investors look back, they will consider this one of the periods of great opportunity: many stocks, bonds and preferreds are cheap, pay dividends, have high interest and are in excellent financial condition; the economy is growing; and alternatives like CDs, T-Bills and the like pay such low rates that they erode purchasing power. Despite the state of the economy, its expected slow growth and, of course, the current volatility, we are very optimistic about the investments we own.

Sincerely,

Barry Hyman- Hawaii Office