

Current Observations

Values and Virtue By Paul Sutherland, CFP®

At FIM Group we are forward-looking, value-oriented investors who believe that we are compensated for risk by including a margin of error in each investment we make. The margin of error comes from paying the right price. We use diversification, asset allocation, careful security selection and emotional peace as our investment tools, and we are always weary of the “five poisons” that can affect the investment decision-making process.

My brother dropped by my house last Sunday morning and said, “Did you know Warren Buffett is a Buddhist?” “Huh?” I said, looking up from a spoonful of Cheerios destined for my 22-month-old son, Patrick’s, mouth. “Yes! He said that emotional peace is one of the keys to his success!” We chatted about that for a while, and then I told him about another investor who had virtue written all over him – Sir John Templeton. There is no single investor who has had more influence on our firm’s old-timers – namely, Jeff Lokken and me – and our investment philosophy. In his foreword to the book *Investing the Templeton Way*, Templeton stated that he relied on the following motto throughout his investing career: “To buy when others are despondently selling and to sell when others are avidly buying requires the greatest of fortitude and pays the greatest ultimate rewards.”

While he did not specifically mention “inner peace,” I think Templeton’s use of the word “fortitude” communicates the same message. Templeton, like Buffett, didn’t allow the noise of politics, self-serving Wall Street and the hype of investment fads to sway him from his mission. Both he and Buffett stayed true to their investing theme of searching worldwide to be compensated for taking on the risk of investing, and to be goal-oriented – not fad-oriented – in their investment approach. I can find little approval for indexing, benchmarking, passive asset allocation, laddering, hedge fund leveraging, using trust companies as advisers, or consultants that can give you history but not discuss the future. Both Buffett and Templeton



Sir John Templeton

THE FIVE POISONS OF INVESTING

Endowment

Recency

Inertia

Heretics

Oversimplification

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knew about the future, and both had *The Intelligent Investor* by Benjamin Graham (1949) on their bookshelf.

Sin of Sloth

Growing up, I attended catechism classes at St. Phillips, but I was not allowed to go to confession because I lacked one important criterion – I was not Catholic. So despite giggles and notes being passed during class, I managed to learn a bit about sin and virtue. The “high scholars” we were, we interpreted sloth, one of Catholicism’s “seven deadly sins” as simply, doing anything that we found fun. While the priest talked about attractive, seductive distractions and how they could lead us to sin, we of course thought about those attractive, seductive, distractions and let the sin part lie at the steps of St. Phillips.

Today, I realize that I have recently succumbed to the sin of sloth. Over the past few months I have allowed myself to get caught up in a dialogue that really has little to do with investing, but which both Jeff Lokken and I love to discuss: politics and political economy. While politics does have something to do with investing, it is not investing, and it certainly is a waste of time to spend valuable newsletter time writing about politics. In other words, it is *part* of the landscape, but is not *the* landscape. Chatting about tax laws, Obama’s philosophy on health care, McCain’s fix for the banking industry or Clinton’s Internet globalization agenda, while useful and seductively interesting, is in large part a waste of time in the world of investing.

Politics in Perspective

Global political dialogue is interesting and can indeed influence capital flows, but it is merely one input among thousands that can affect investing. And for investors to concentrate their efforts on the political influence on any one investment, then, really is an insidious, irresponsible, slothful waste. Americans seem to especially enjoy wallowing in politics, the slimy underbelly of our

American life. My gosh, if you’ve listened to talk radio or Fox News lately, you would think that the future of capitalism and the free world rests on the ability of unions, associations and businesses to continue to buy votes unencumbered, which of course concerns us here at FIM Group as Americans, but really just helps certain industries and creates barriers for others. So I confess I was slothfully giving various political commentators more time than they were worth. America is too big, and we are too smart to let a few Republicans or Democrats ruin our democracy or capitalism for that matter. Capitalism is what works in the world. It is messy, politicians will mess with it, populists will sway the masses, large businesses will create barriers to competition and creative destruction will happen in America because we are capitalists.

Templeton’s ‘10’

Back in the 1970s, we set out to find our place in the overhyped, seductive, oversimplified world of investing that was full of guaranteed annuities, “Nifty Nifties,” blue chips, gold bugs and real estate partnerships, and we felt that Sir John Templeton’s long-term, values, virtue and common-sense approach would be our fort. Templeton had 10 maxims* that we incorporated and made our own. While Sir John may no longer be with us, his words are as timely today as they were back then and, of course, we have now nearly 35 years of working on the fortitude and inner peace bit of his core teaching.

Invest for real returns

The true objective for any long-term investor is maximum total real return after taxes.

Keep an open mind

Never adopt permanently any type of asset or any selection method. Try to stay flexible, open-minded and skeptical.

Why follow the crowd?

If you buy the same securities as other people, you will have the same results as other people. . . . To buy when others are despondently selling and to sell when others are greedily buying requires the greatest fortitude and pays the greatest reward.

Everything changes

Bear markets have always been temporary. And so have bull markets.

Consider avoiding the popular

Too many investors can spoil any share selection method or any market timing formula.

Learn from your mistakes

‘This time is different’ are among the most costly four words in market history.

Buy during times of market pessimism

The time of maximum pessimism can be the best time to buy, and the time of maximum optimism can be the best time to sell.

Hunt for value and bargains

In the stock market, the only way to get a bargain is to buy considering what most investors are selling.

Search worldwide

If you search worldwide, you will find more bargains and better bargains than by studying only one nation.

No one knows everything

An investor who has all the answers doesn’t even understand the questions.

Play Nice

I believe that because of John Templeton’s deep faith and worldview, he felt it was self-evident that virtue, ethics, honesty, transparency, a common good orientation and sustainable business models were important and should be included in any investment philosophy statement. I also believe that he felt that adding them to his maxims would be as redundant as reminding an adult to “play nice.”

If you interested in reading the book *Investing the Templeton Way; The Market-Beating Strategies of Value Investing’s Legendary Bargain Hunter* e-mail info@fimg.net or call 231.929.4500, and we will be happy to send you a complimentary copy.

*Source: Templeton Maxims, published by Templeton Investment Management Limited

Recent Frequently Asked Questions by FIM Group Clients

By Barry Hyman, MBA



Q: “Now that my portfolio has recovered much of 2008’s declines, should I sell, move some money to cash or move to a different FIM Group portfolio risk tolerance category?”

A: Those are portfolio management decisions FIM Group considers on our clients’ behalf continuously, not just during periods of volatility. The short answer is that we are already doing this to some extent. When the market reached its bottom in March of 2008, there were so many bargain-priced investments that our challenge was to separate the “super bargains” from “regular bargains” and invest accordingly. The performance of our accounts in 2009 achieved our objectives of doing better than that of the broad market indexes. With the strong performance of many investments during the first leg of the recovery, some had reached the prices we expected and no longer presented a favorable risk-adjusted potential as they once did. As value-oriented, disciplined managers, “price to intrinsic value” is one cue to exit such investments. Notwithstanding those that have reached our target prices, there is still tremendous value in the securities we continue to own and those we are buying, many of which are concentrated in pockets of the market. *(See Suzanne Stepan’s article about energy on page 4.)*

On a macro level, we feel broad markets have recovered to the point at which values of entire indexes are also no longer priced at favorable risk-adjusted bargain levels. The investment landscape has gone from a “kid in a candy store” environment to one in which security selection has become even more critical than normal. If you monitor your portfolio closely, you will have noticed the selling of select securities recently, specifically in the equity-oriented FIM Group “Growth” and “Balanced” portfolios. We have been “ringing the cash register,” selling some of the positions we own as well as “cleaning house” by reducing others that are no longer compelling. We are redeploying

the cash into more defensive positions and increasing the concentration in positions that we believe still offer sufficient risk-adjusted, long-term return potential.

Q: “What goes into FIM Group’s decision-making process when determining what to sell and when? Sometimes it seems like you sell too early, while other times it seems you wait too long. Still other times it seems like you just give up while there are some positions in my portfolio that have sat there for years doing very little.”

A: There is a complex array of reasons that factor into our decision to sell an investment. The simplest one is when a security approaches our “sell target,” but even that is not a static condition. Whenever we make an investment we establish a price that we feel is a “fair value” for the security based on our fundamental analysis. We consider many other factors – such as a company’s products and services, competitive forces, debt and financial condition, cash flow, and the ratios between its price and the current and estimated cash flow, income, revenues, etc. – but all of those things can change over time.

Another common reason to sell an investment is to replace it with better opportunities as they become available. For example, in FIM Group growth accounts we look to purchase equities that provide additional returns from dividends and potential currency gains. In some cases, we will sell a perceived “good” investment to replace it with one we feel has superior return potential. In other cases, we may sell an investment in a growth account but continue to hold it in our income-oriented account if the price has gotten closer to our sell target, but the dividend income still meets our objective.

It is important to understand that our process is not static. If we buy something and it rises to our sell target quickly, we will likely sell some or all of it. But a quick appreciation to

our sell target is the exception. More often, before an investment meets our initial sell target, the fundamentals may improve, in which case our sell target will rise, or deteriorate, and our estimate of fair value declines. A major mistake investors can make is to stay fixated on original assumptions or price targets. To be successful you must be able to reevaluate each investment continually, especially as new information becomes available, with no attachment to prior decisions or assumptions. Remember, flexibility reduces risks. Sometimes it is the case that assumptions made about a specific company still hold, but the macro environment, competition, government regulations, etc. for that company or industry has changed.

It is also paramount to be able to ascertain whether the market is misreading or overreacting to endogenous or exogenous factors. The fact that the market price of an investment has declined does not necessarily mean that it is worth less. Rather, it may simply be the result of the market being “inefficient” or emotional, presenting an opportunity to increase the size of an investment. Rather than selling along with the masses, it can pay to be contrary.

A description of the rationale behind some recent positions we have sold or are in the process of selling in various client accounts may help shed light on some of the complex reasons we decide to sell an investment. Please keep in mind that not all of these investments were appropriate in every client account, so it may not have been held in your account based upon your personal strategy. We also might not be selling the securities in each account they are held.

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KPJ Healthcare – Health care is one of our most favored sectors, and KPJ Healthcare is a holding in many of our growth and balanced accounts. KPJ operates medical centers and provides health care services. We especially favor medical tourism and emerging economy hospitals, and KPJ is one of our favorite companies in this space, so selling it is like saying goodbye to an old friend. The price of the stock has run up to historic high valuation levels and has simply become too rich for our blood.

STO – Statoil ASA is a Norwegian oil and natural gas company. This sell was for reasons quite opposite those of KPJ. We originally began purchasing STO in September 2008, at the beginning of the financial crisis. We continued to like this company and purchased it throughout 2009. It paid us an annual dividend ranging from 3.75% to over 4% and we like energy companies and favor foreign currency-denominated securities. We

liked STO's price-to-value relationship and its dividend, but the company recently made a few decisions, some of which were questionable in our mind and others that we feel were detrimental to the company's financial health. We felt its implied risk has increased, and therefore it no longer qualified as a position we feel worth holding.

ELNK – Earthlink is an Internet Service Provider that offers services across the Internet delivery spectrum. Because Internet access has become a basic necessity in today's world, their business is somewhat defensive to economic cycles. The company generates around \$0.25 quarterly in cash flow for each dollar of stock and sells for less than its book value. Those are some of the qualities we look for in an investment. We liked this company at its current price and even higher prices as recently as last year. But we have become concerned about the competitive environment specific to Earthlink and the fact that

the company has not deployed its cash to diversify or raised its dividend to send shareholders more of its profits. There are other investments we believe offer more benefits to our portfolios.

Most sell decisions are far too complex to briefly explain in a newsletter. They are made based on a complex matrix of the company's specific financials and market-related factors, paramount of which is preference for other investments we would rather own. In short, we sell for three broad reasons: 1) When a security reaches its fair price, 2) when we find something we like better, or 3) when its price-to-value or fundamentals erode.

We are always available to discuss your portfolio, so please don't hesitate to contact us with any questions.

**Please see disclosure on page 6.*

FIM Group's Energy Focus

By Suzanne Stepan, CFA®, MBA

A report released last year estimated the United States' wind energy market at \$150 billion. The 2009 U.S. wind market is dwarfed, however, by the amount spent on wind and alternative energy sources in other parts of the world. Wind energy is used in more than 70 countries and generates just under 2% of world energy use, so there is significant growth potential. On January 11, the United Kingdom announced an initiative that they would be deploying 32 gigawatts (GW) of capacity by 2020. To put that into perspective, 32 GW can supply power to 7.2 million to 9.6 million households in a single year. The U.K. has roughly 22 million households, so if all goes to plan the U.K. will have up to 44% of households utilizing wind-produced energy by 2020.

In 2009, the American Wind Energy Association reported that the U.S. broke a record by adding 10,000 MW of new capacity that can serve more than 2.4 million homes. The U.S. Department of Energy recently announced its goal of obtaining 6% of U.S. electricity from wind by 2020 – a goal that is consistent with the current rate of growth of wind energy nationwide.

At FIM Group, we believe wind energy will be a strong sector in the future; therefore, we devote time to actively research, analyze and invest in both the wind and energy sectors. Many FIM Group portfolios hold numerous companies that are involved in wind energy and other areas of energy creation and distribution. Many companies, like the U.S.-based Otter Tail Corporation,



Top Wind Installations

- 1) Germany: 16,628.8 MW
- 2) Spain: 8,263 MW
- 3) United States: 6,740 MW

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operate with several subsidiaries that provide diversified energy product offerings. Otter Tail's subsidiaries include:

Otter Tail Power Company, which provides electricity for DMI Industries, which manufactures giant steel towers for the wind energy industry Aevenia, Inc., which provides design, procurement, project management, installation, maintenance and safety to cover every vital phase of a project. Companies like the U.S.'s Exel Energy, Australia's Infigen Energy and Europe's Energias De Portugal all invested in wind farms and sell energy resources to customers in their respective markets.

What do we look for in our wind and alternative energy investments?

- 1) **Stellar management**
- 2) **Good market area**
- 3) **Conservatively managed balance sheet**
- 4) **Reasonable regulations**
- 5) **Diversified product offerings (gas, hydro, wind, solar, etc.) and/or geographic diversification**
- 6) **Solid cash dividend supported by current cash flow and future earnings**

7) Priced right – this area has a tendency to get overpriced as overzealous “Wall Street marketers” hype stock prices to unreasonable levels

Thankfully the market tsunami of early last year brought energy stocks down to reasonable levels and in some ways separated the common-sense winning strategies from those that were inflated on hype. We are pleased that we were able to buy such a quality portfolio of solid energy companies at great prices. Some of FIM Group's client holdings include: Criteria Corp, Pargesa and Cheung Kong Holdings, which provide exposure to both traditional and alternative channels of energy. For example, Hong Kong-based Cheung Kong Holdings owns a large chunk of Hong Kong Electric, which built Hong Kong's first commercial-scale wind farm – Lamma Winds.

For more information on our wind and other alternative energy investments, visit www.fimg.net. There, you'll find links to the World Wind Energy Association (www.wwindea.org) and the websites of the companies mentioned above.

*Please see disclosure on page 6.



New Tax Law Regarding IRAs

By Kevin Mahoney, CPA, CFIS

With the ongoing health care debate dominating the news, many people are unaware of one tax law change that took effect on January 1, 2010, that could significantly impact many taxpayers for years to come.

Effective this year, any taxpayer may convert a Traditional Individual Retirement Account (IRA) to a Roth IRA. In previous years, this was restricted to those taxpayers with a modified adjusted gross income below \$100,000. While this change may seem

minor at first, serious consideration should be given to converting IRAs for several reasons. This article will explain the difference between a Traditional IRA and a Roth IRA and discuss the pros and cons of converting a Traditional IRA to a Roth IRA.

Created in 1974, Traditional IRAs provide taxpayers an immediate tax deduction for contributions made into the account. There are no income taxes paid on the account until funds are withdrawn. As long as withdrawals are

made after age 59½, they are taxed as ordinary income. Withdrawals can be delayed until age 70½, at which point annual required minimum distributions (RMD) must be taken.

In contrast, contributions to Roth IRAs, which were created in 1997, do not result in a current income tax deduction. However, as long as withdrawals are made



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after age 59½, no income taxes are due. In addition, Roth IRAs are not subject to the RMD requirements.

In general, there is no economic benefit of a Traditional vs. a Roth IRA for most individuals as long the following assumptions are made:

Future income tax rates are the same as current income tax rates.

Assumed earning rates are the same for all time periods.

There is no estate tax liability due on the IRAs upon the death of the account owner.

For 2010, current tax law allows an individual to convert a Traditional IRA to a Roth IRA and elect to pay the income taxes currently or defer the tax liability by reporting one half of the amount converted in 2011 and one half in 2012. It is important to note that this is the taxpayer's option, giving more flexibility and more income tax planning opportunities.

In most cases, it is not beneficial to pay the income taxes due on conversion from the IRA account itself.

For those individuals whose estate may be subject to estate taxes upon their death, the Roth conversion would result in a lower taxable estate, since the income taxes paid upon the conversion would reduce the total assets of the estate. In addition, married taxpayers may want to consider a Roth conversion as a way to reduce future income taxes for the surviving spouse. Since the surviving spouse will be required to pay taxes at higher single taxpayer rates, converting to a Roth IRA will not only eliminate future RMDs but would also result in any withdrawals being income tax-free.

In general, a Roth IRA is more "income tax-friendly" to a non-spouse beneficiary, since any withdrawals are not subject to income taxes.

One often overlooked aspect of Roth IRA conversions is the ability to "recharacterize" a converted IRA. This in effect allows you a "do over" if the value of the converted IRA suffers a significant drop in value from the

date of conversion to the due date of the tax return including extensions (currently October 15 of the following year).

Recharacterizing a Roth IRA is an "all or nothing" option; one cannot pick and choose which investments within the account can be recharacterized. However, a taxpayer can create multiple Roth IRA accounts, giving one the option of only recharacterizing those accounts, if any, that drop in value.

So is a Roth IRA conversion right for you? This is not an easy question to answer. On one hand, you are in effect "pre-paying" income taxes. This has to be weighed against the benefits listed above and what income taxes will be in the future.

If you would like to explore the Roth IRA conversion further, you may contact your FIM Group adviser who will be glad to evaluate your personal situation.

For more information about the history of IRAs, visit www.essortment.com/career/v.

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