



Q3 2009 Notes on the Quarter

Overview of the Quarter:

- 1) The third quarter continued to show improvements in most markets. The S&P 500 gained 17.03%, the Dow Jones Industrial Average rose 10.66%.
- 2) The credit markets continued to tighten along the entire curve: the 30 year bond is at 4.05% from 4.33% (a 6.4% drop) three months ago and the 10 year is down to 3.30% from over 3.53% (6.5% drop).
- 3) Commodities were mixed: energy prices were range bound, most soft (agricultural/foods) were flat to down and metals were all up.

Portfolio Specifics:

- 1) We have been early with our profit-taking, but better early than late. The markets continue to climb a wall of worry, but with few fundamentals to justify the climb, we are very concerned about the valuations and therefore the price risk of most stocks.
- 2) The U.S. is now the home of the carry trade. The U.S. dollar is the basis of that trade – if the dollar is up, the markets and commodities are down, when the dollar is down, stocks and commodities rise. This trade is just that – a trade – not an investment.



Looking Ahead:

“Plus ça change, plus c’est la même chose.” (“The more things change, the more they stay the same.”)

~ 19th century French Proverb

This has been one of the hardest letters I have written in a very long time. The issues are so important to successful investing and yet they seem so disparate one will at first think I am rambling. However, by the time I am done, if I have been successful, the relationship between the topics will be self-evident.

Economic Realities

In 1999 there was a massive bubble in the stock market which came to be known as the “Tech Bubble.” Thanks to the low cost of money, a great deal of leverage, and investors’ voracious appetite for quick gains, this bubble grew to enormous size and burst in 2000. Mr. Greenspan, then Chairman of the Federal Reserve, kept rates low because he didn’t want the burst to lead to a huge recession, which he achieved. This was followed by the attacks on 9/11 and once again, the medicine for the ailment, according to Mr. Greenspan was to keep rates low. This led to a new bubble which we have come to know as the Housing Bubble. Again, Mr. Greenspan determined the best remedy for this was to keep rates low with the hope that the bubble would slowly deflate rather than burst.

When Mr. Bernanke replaced Mr. Greenspan as Chairman of the Fed he continued the same policies. The Housing Bubble burst, as bubbles always do, because the excesses became so overwhelming that prices imploded: it was a case of who would blink and run for the exits first.

The Housing Bubble was really a financial leverage bubble which included housing along with many other fancy forms of synthetic debt structures that Wall Street managed to sell to just about anyone who would listen. Not only was this bubble very broad in its scope, but also in its breadth – this was not a U.S. phenomenon, but truly a global phenomenon.

When this latest bubble burst, the true level of leverage throughout the economy, both in the U.S. and abroad, manifested itself. It turns out most banks and investment banks, mutual funds, ETFs, hedge funds and private funds were leveraged. This meant, indirectly, so too were pension funds, 401k funds, IRA funds and individual and institutional investors. This of course, was on top of the direct leverage individual investors had accumulated thanks to that eternal generator of cash (much like the Fed) – their house.

What has allowed all of these bubbles to occur is a combination of: 1) low interest rates; 2) spectacular leverage; 3) accounting rules that allowed for this leverage to be hidden off-balance sheet; 4) government regulators who did not regulate because the politicians they represent benefited from the bubble and so did not want it to end; and 5) investors who forgot what taking risk means and who to this day still believe that fortunes are made overnight.

Looking Ahead (continued):

Are you beginning to see a trend here? Every time there is a bump in the economy, the government's answer is to move interest rates down and then keep them there. This is, of course, what generates the bubbles in the first place! And guess what? This is happening again. Mr. Bernanke has determined that low interest rates are critical to survival and thus we still have interest rates near zero.

With interest rates artificially low and government spending unsustainably high, we are creating a new bubble, although were it will manifest itself is still unclear. It may be in the dollar as a carry trade, and as part of that, U.S. treasuries. It may be in commodities. But rest assured a new bubble will develop because the factors are all still there: 1) cheap money; 2) leverage (yes the investment banks are leveraging up again); 3) the conflict of interest between politicians and the investment industry; 4) balance sheet regulations that have not changed; 5) investors mostly interested in a quick buck.

The U.S. Dollar Conundrum

As has been discussed everywhere, the U.S. dollar has weakening dramatically in the past few months. But to put the movement in perspective, a closer look at history will be helpful. Chart #1 compares currencies over a long period of time, chart #2 just this year. The first thing to notice is that the value of the dollar (and other currencies) changes over time – it goes up, it comes down. The fact that the value changes is not, in and of itself, particularly alarming.



Chart 1: U.S. Dollar vs. Euro vs. Japanese Yen – 34 yr period 3/31/75 – 9/30/09 – data provided by Bloomberg

Looking Ahead (continued):

However, the dollar has been in a downtrend now for almost a decade. This is certainly a concern, but before we discuss why the dollar has been so weak for so long, look at chart #2. Notice that the dollar rallied substantially between the middle of last year into March of this year before retreating. This coincided with the breakdown in the stock, bond and commodities markets due to the credit collapse; notice the S&P 500 hit lows at time the dollar hit highs, and as the markets have recovered the dollar has once again weakened. Also note that the dollar while down in the past six months, is not at the lows touched in 2008 (see chart #1 and chart #3).

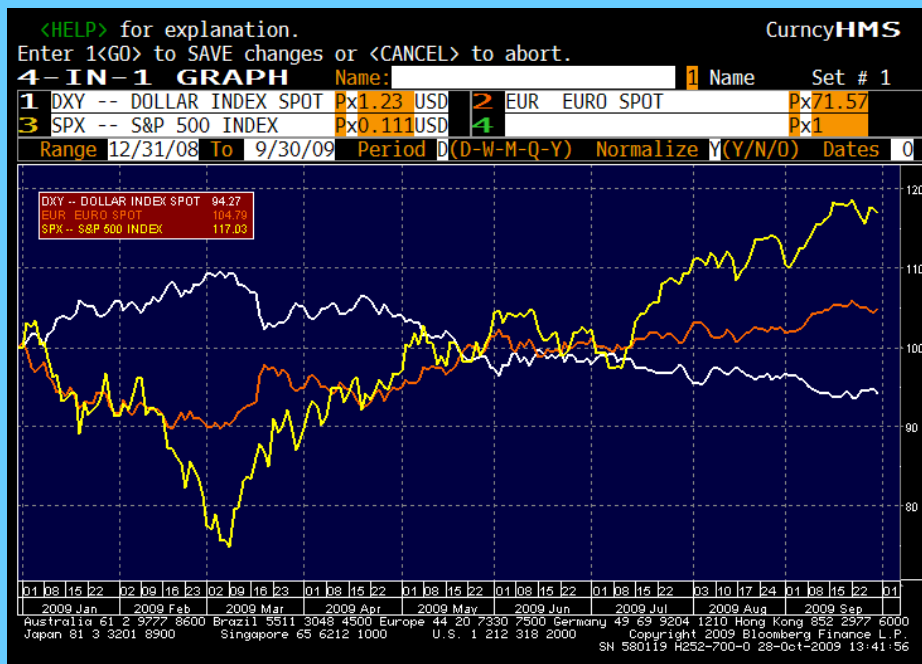


Chart #2: U.S. Dollar vs. Euro vs. S&P 500 – YTD 12/31/08 – 9/30/09 – data provided by Bloomberg

The dollar is down 36.6% from its high in 1999. It is down 14.5% from its high in March of this year, but is up 7.5% from its lows in 2008. But what does all this mean besides that currencies are volatile and traders love playing in the forex sandbox?

It means that the U.S. government has had a weak dollar policy for the past ten years. With an economy that has grown largely artificially in the past decade (extensive use of debt magnifies growth rates) and mounting U.S. debts, the cheapest way to pay back the debt and easiest way to stimulate the economy is to have a weak dollar.



Looking Ahead (continued):

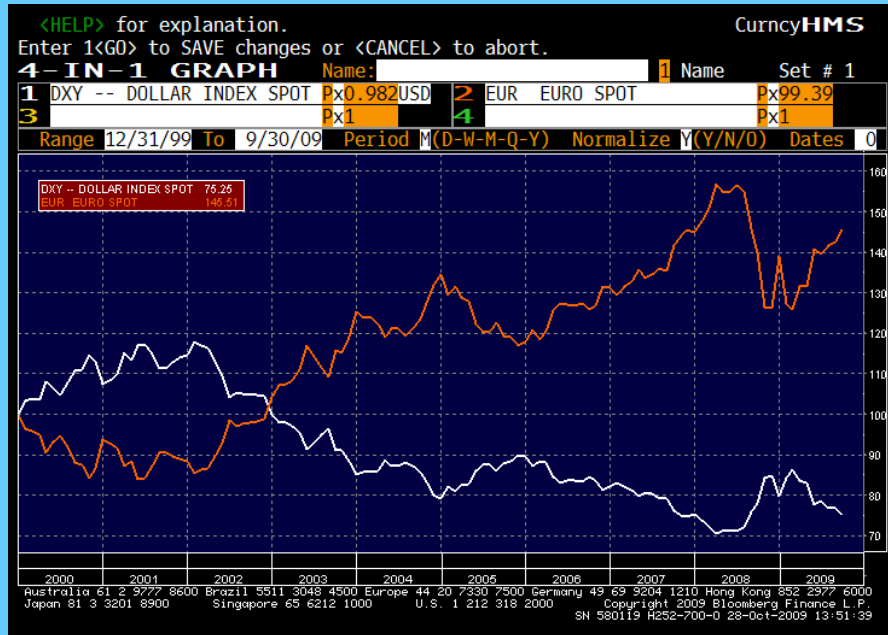


Chart #3: U.S. Dollar vs. Euro 12/31/99 – 9/30/09 – data provided by Bloomberg

There are several problems with this long term strategy however. First, a weak dollar imports inflation. The world is perfectly aware of what the U.S. is doing and thus, in order to maintain their own returns, they raise prices to adjust for the dollar weakness. Typically, this leads to reduced spending and a recession which readjusts all these issues. However, when we import so much of our daily needs, from clothing to food to electronics to energy, though we may spend less, we cannot stop buying completely, and thus we import inflation.

Second, while the Fed can control short term interest rates, they cannot control long term rates. A weak dollar will induce both domestic and foreign investors to own less long term treasuries which raises borrowing costs and, you guessed it, increases inflation.

Third, other countries, for a variety of reasons, are looking to reduce the influence the U.S. has on the world. One of the ways to do this is to come up with an alternative to the dollar as the world's reserve currency. A weak dollar currency plays into these other countries' hands.

China and others have been working on ways to diversify away from the dollar by investing in commodities and making purchases in currencies other than the dollar. Over time, if the U.S. wants to be of financial importance to the world, we need to be looked to as a stable, safe place to do business and this requires a stable currency.

Looking Ahead (continued):

“Investor” Behavior

For the past ten years, and even more so in the past three, the stock market has acted less like a place for long-term investing and more like a forum for gambling à la Las Vegas. Volatility has gone up significantly: a 10% move in a stock took a year, now the markets move 15% in a quarter and stocks move 20% in a week. 1% daily moves in the averages have become commonplace.

The easy access to leverage (I know - I keep repeating this), ETFs invested in commodities and foreign currencies, and Wall Street’s profit motives are components in this speculator’s market. What needs to be addressed is why and how is it impacting long-term investors?

Let’s start with a few facts:

- 1) High velocity trading accounts for ~60% of current volume on the American exchanges;
- 2) Low interest rates in the U.S. now make the U.S. dollar the basis of the carry trade;
- 3) The SEC is not closing down many forms of high velocity trading;
- 4) Major trading firms like Goldman Sachs use significant leverage with their high velocity trading. Goldman’s net revenues for the latest quarter were \$12.372 billion, of which \$10.027 billion came from Trading and Principal Investments (81%).

CNBC, MSNBC and Bloomberg Television all have programming focusing on the markets; all day, all night, never ending! Their shows are filled with advice for what to do by the minute, by the day -- none of it is for long term investing. Pundits time and time again declare that the buy-and-hold strategy is dead.

E-Trade, Scottrade, Schwab, Fidelity – they all advertise on how they have a great *trading* platform so you can trade effectively and perhaps even profitably.

What all this adds up to is Wall Street is trying to convince investors that they should trade. The reason is that it makes Wall Street money. They make BIG money. But in order to make big money, you need: 1) lots and lots of capital, so you borrow it because interest rates are low; and 2) volatility, so you want lots of people jumping in and out. Of course, it becomes self-fulfilling because the leverage allows you to create the volatility.

This is not illegal, this is not immoral and this is not investing. Long term investing is not dead – it is simply been relegated to a relatively small role on the U.S. exchanges compared with trading. The increased volatility means that investors, those who, based on long term economic fundamentals, desire to own a piece of a business, must accept the fact that there will be much more volatility in the marketplace than in the past.



~ The Bottom Line ~

“Neither a borrower nor lender be...And borrowing dulls the edge of husbandry”

~ Hamlet Act 1 Scene 3

Volatility is a fact of life that long term investors must accept. It will impact all of our economic issues making it difficult to make many intermediate term (six months) decisions. However, this volatility makes being a long term investor, rather than capitulating and morphing into a trader, imperative. First, because it will provide more consistent long term returns and second, because trying to compete against professional traders who are getting a flow of information that you do not have access to is a losing proposition.

Strategies going forward:

- 1) Stay away from leveraged investments and companies. The financial stocks are not likely to be very attractive for some time. Things you build with will be the winners this go round.
- 2) Recognize risk for what it is – the possibility of losing money. High risk does not guarantee high returns – if it did everyone would do it and the returns wouldn't be high. Note that even with the 17% return of the S&P 500 this year, it is still down more than 20% over the two years! For those that took all that risk they have lost a small fortune – 20% of their net worth.
- 3) Long term, inflation is a serious risk in the U.S. However, as noted, the dollar was the safe haven the last time there was worldwide fear. Huge numbers of professionals and retail investors are betting on a weak dollar, strong commodity prices and strong Asian economies. While I believe this will be correct in the long run, it is a very crowded position and thus the opposite could happen: the dollar could rally if the world economy is not as strong as predicted, leading to lower commodity prices and weaker Asian economies. With the leverage in the system, this could happen extremely fast.
- 4) Investors must stay focused on fundamentals. If you focus on the economics of your investments rather than the price, you will not get whip-sawed by emotions as volatility will continue to stay high for some time.
- 5) Diversity does work. Diversification does work when you don't use extensive leverage. Leverage is what made so many asset classes correlate in the past two years. True diversification will help reduce portfolio risk and will help produce solid results.



~ *The Bottom Line (continued)* ~

The **Bottom** Bottom Line:

We want to have exposure to Asia (Singapore, Viet Nam, India, China, Australia, and Hong Kong) and Brazil. We also like commodities and industrials. However, in order to invest at reasonable prices, we need these areas to pull back.

We will need to be very contrarian, buying when others are selling. As long as we stay focused on a three to five year horizon, and stay focused on the fundamental values rather than changes in current prices, we should continue to be successful.

Currently, the markets are overly euphoric about the U.S. and Asian economies and company earnings and pessimistic on the dollar. This can be seen from the following data: 1) Recent equity mutual fund inflows are near highs for the year; 2) Chinese P/Es are as high as at the peak of the market in 2007; 3) metals and precious metal prices are at highs but seem to be rolling over; 4) various economic data (railcar loadings, consumer confidence and latest GDP numbers) do not corroborate current equity market valuations; 5) the dollar trade is very crowded. The contrarian attitude would thus be to be cautious on stocks until we get a pullback.

Remember that *investing* is a long term strategy much like being a winning athlete. You have to execute every day; your career success is not based on a couple of games where you were particularly hot, but based on consistent, long term performance.

Alan E. Rosenfield
October 2009
480-314-5967