



Commentary
by Steve Henningsen
July 2004

*"The obscure we always see sooner or later;
the obvious always seems to take a little longer."*
Edward R. Murrow, former CBS executive

For those who wish only to know what's going on with their investments, go to Portfolio Happenings at the end. Those who wish to read about a conference I recently attended, see below. Those who have the stamina and wish to peruse my usual diffuse ramblings: splash some cold water on your face, grab a cup of jo and proceed from beginning to end. ☺

2004 AIMR Annual Conference

I'm not usually one for conferences, because most are geared towards product pushing. However, I was excited to attend the recent Association for Investment Management and Research (AIMR) conference since many of the speakers were professionals I respect and the fact that it was being held in Denver made it very convenient. Following, I have summarized some of the more interesting presentations I attended.

The Real Bull Market—Jim Rogers

Jim has an interesting background, being the ex-sidekick of George Soros (they used to run a very successful hedge fund together) and having traveled around the world twice, once on a motorcycle. Jim is what I refer to in the investment world as a macro thinker, in that he sees the whole world as his investment basket, a view that I tend to share. Much of his talk was regarding his recent trip around the world, but it centered on his main investment theme—we are in a bull market in commodities. To him it is simple supply and demand. There has been no major capital invested in commodity producers in the last 20 years and because it takes a long time to bring supply on stream, this up trend in commodity prices will last many years.

Not surprisingly, he is also a big China fan (he has a Chinese nanny to teach his daughter the language) and thinks they will lead the 21st century as America did the 20th. “When China has a setback—buy!”

The Impact of World Politics on Investment Management—Marvin Zonis

Marvin is a professor emeritus at the Graduate School of Business at the University of Chicago, heads an international-risk consulting group, and is a leading authority on Middle Eastern politics. He outlined what's going on around the globe currently and provided many interesting statistics— did you know the U.S. spends approximately \$471

billion dollars on the military, which is larger than the sum total of 45 other countries, including China, U.K. and Russia?

He did not have nice things to say about the “neo-conservative party,” aka the “White House,” and the backlash resulting from America forcing its beliefs and policies on the world. He also pointed out that most of the “threats to rich countries come from failing states.” These 60 poor countries represent 20% of the world’s population and unfortunately, are the same countries that have the biggest population-growth numbers. This, combined with the fact that there is little investment in the Middle East and almost no education system, is making for a breeding ground for fundamentalist Islamists. 300 million people in the world speak Arabic and 11 million speak Greek. However, more books got translated into Greek in 2003 than Arabic– “these people are not getting information!” *More people in sub-Sahara Africa are on the Internet than the whole Arab world.*

He also pointed out challenges concerning energy, especially given the dissent in the Saudi ruling family. Even though energy spending as a percentage of our economy (GDP) is only 6%, compared to 14% in the 70’s, we are increasingly more dependent upon imports, as domestic production has been in decline for many years. Also interesting (at least to me) was a chart showing car ownership per 1,000 people, as it listed the U.S. at 486 people, China at 3.2 and India at 4.5. Given that China and India represent billions of people, what happens to oil demand if their numbers only increase slightly? For you trivia buffs, Lebanon has the highest car ownership with 732 cars per 1,000 people.

The Pension Fund Crisis–Ronald J. Ryan, Ryan Labs Inc.

In a nutshell, private pension plans have a deficit of \$260 billion and public plans are underfunded by \$300 billion. Eventually, this will present a drag on corporations’ future earnings because they will need to increase their contributions to their plans and also need to pay higher premiums to PBGC (Pension Benefit Guarantee Corporation). PBGC's single-employer program insures the pensions of 34.5 million Americans in 29,500 plans.

On a side note, I discovered on their website that PBGC has an unaudited deficit of \$9.7 billion as of March 31, 2004, and has approximately \$85.5 billion in "reasonably possible" exposure, defined as the amount of unfunded vested pension benefits promised by financially weak employers. My guess is that my fellow taxpayers and I will be on the hook for this bill.

The Changing Face of the Investment Management Business–Ray Dalio

Ray is the Chief Investment Officer and founder of Bridgewater Associates, a large institutional investment manager. Ray is one of those guys that everyone in the audience (well, maybe it was just me) has to really pay attention to because he is on a higher level of thinking. His basic premise is that the future of investment management will be in separating alpha and beta. *Whoa Steve, don't go Greek on us!* Let me back up. Alpha and beta refer to two of three return streams in the investment world (Total return = Risk-

free rate + Beta + Alpha). Beta reflects asset class performance and is simple to obtain through investing in an index fund; i.e., S&P 500 Index will reflect the return of the U.S. large cap market. Alpha represents that portion of an investment fund's return that is generated solely by the skills of the portfolio manager. The return of a U.S. treasury bill is typically used for the Risk-free rate, being that Uncle Sam guarantees it. In order to determine whether an investment manager provided any alpha, you would need to back out beta and the risk-free rate and whatever value is left was manager skill.

I have discussed these variables many times in the past, just not in this context. For example, we use passive (index) type investments in client portfolios to obtain beta returns and active managers for obtaining alpha returns. In my past few commentaries, I explained how we were transitioning from an overweighting in index investments (beta) to active managers (alpha), since I believe that the equity markets will be relatively flat over the next few years as opposed to the bull market of the 90's.

Ray was saying that due to the need for higher returns and uncorrelated investments, investment managers will be separating these two returns and combining them using leverage to better balance risk and returns. This is sometimes referred to as portable alpha, in that it attempts to generate alpha for a total investment strategy by combining a purely active, non-correlating overlay strategy with a low-cost portfolio that represents the investor's exposure to the market. Got that?

I compare it to how a cook can separate out the different ingredients in a recipe and reconfigure them for different tastes. I'll stop there on this subject as the eye-glaze meter is rising. Suffice to say that in the years ahead many in the investment world will be doing everything they can to squeeze investment returns from the markets, as the low hanging fruit is gone.

The Outlook for Energy—Thomas Petrie

Tom is the Chairman & CEO at Petrie Parkman & Co., a specialized investment-banking firm focused on energy issues. His view is that energy will take center stage over the next decade as growth in demand outstrips supply. Whereas \$16 to \$22 was the past trading range for a barrel of oil, \$40 to \$60 could be the new trading range. Yes, new sources of oil exist, but it is getting harder and more expensive to obtain. He cited the following forces shaping the petroleum landscape for the balance of the decade:

- Maturation of the conventional petroleum base
- Middle East dynamics/imponderables
- Economic growth in China and India
- Maturing of Russian export capability (they have their own needs)

This should result in intensified global competition for energy supplies. There are new sources of energy, such as liquid natural gas (LNG); however, roughly \$150 billion needs to be invested in it over the next few years. I would also add that I have noticed that many of the communities surrounding the potential U.S. shipping ports have demonstrated and prevented LNG from being offloaded due to terrorist concerns.

If anything, the comments by these presenters gave conviction to my thought process these past years and comfort to the positioning of our portfolios going forward.

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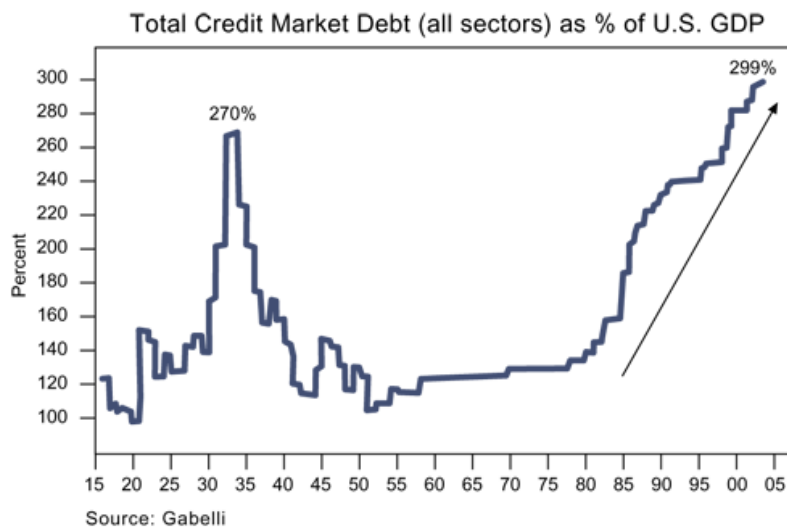
"If you listen carefully, you get to hear everything
you didn't want to hear in the first place."
Sholem Aleichem, Writer

Can we get out of this hole?

"Having gone deeper into debt to purchase McMansions and SUVs in recent years, how do baby boomers intend to spend their golden years? I predict that we baby boomers will turn our McMansions into bed and breakfasts for the increasing number of Chinese and Indian tourists who will be visiting our shores in the next fifty years. And we will provide complimentary shuttle services to our guests with our SUVs."

Paul Kasriel, Northern Trust economist

Like a Sherpa with an SUV on his back, the US consumer trudges onward and upward as the cost of debt increases. The nation's and its citizens' debt problems seem to go mostly unnoticed, like the dinner tab lying in the middle of the table that no one wants to pick up or discuss, with the exception of that Cassandra of the bond world, Bill Gross, who keeps harping about it. I took this chart from his recent newsletter, showing total credit market debt is now higher, as a percentage of US GDP, than it was back in 1929.



Don't worry, most in the investment world pay no heed to Bill's commentary and wish he would just go back to managing bonds and stop commenting on the underlying economy.

I think everyone is counting on some miraculous fairy godmother to come along and bail them out, because they're not doing it themselves. But if they don't do it themselves, then it just ain't going to happen. There are people who have fantasy ideas that somehow miraculously at age 65 they're going to be living in a condo on the ocean or living in a house on a golf course, and it's just not going to happen unless they make it happen by virtue of savings, restraint, discipline and all the things that are in very short supply in American society today.

Ben Stein, Author and financial commentator

If baby boomers are so poorly prepared for retirement, how will they fund it? Well, in addition to Mr. Kasriel's prediction above, my divination is that if interest rates keep rising putting added stress on individuals' debt management, then we will see an increase in reverse mortgage loans over the next few years. After all, it's their last asset to tap.

I have highlighted the frugality of our past generations in prior commentary. However, it appears inflation and the siren call of credit card companies are starting to catch up with these generations as well. A recent article by the Associated Press noted a study by Demos, a New York-based think tank, that found seniors over age 65 were carrying an average of \$4,041 in credit card debt in 2001, almost double the amount reported by seniors 10 years earlier. While not yet a major concern, it is a growing trend among our seniors. The reasons vary, but experts say some retirees are overwhelmed by rising medical expenses or find that Social Security and their pensions don't stretch far enough. Stuart D. Zimring, president of the National Academy of Elder Law Attorneys, said he's seeing more older couples get into financial problems because "cash flow is not keeping pace with the cost of living, particularly the cost of health care."

What Real Estate Bubble?

The one that worries me the most is the property bet. In a jobless recovery, income-short American consumers have turned the levered carry trade into "manna from heaven." Courtesy of relatively costless mortgage refinancing, homeowners have been able to extract "excess value" from their number-one asset holding — and use that newfound purchasing power to augment a seemingly chronic shortfall in earned wage income. But consumers have now crossed a dangerous line: By continuing to parlay the proceeds of this carry trade into spendable income, they have created an artificial bid in property markets that is now in serious danger of turning into a full-blown housing bubble.

Stephen Roach, Morgan Stanley Economist

Obviously, Mr. Roach didn't read the new 12-page study by the Federal Reserve stating the rapid increase in home prices is itself not evidence of a bubble. It sure made me feel better, as well as the two new homeowners highlighted recently in the *New York Times*. One article was right here in my own backyard and highlighted Boulder's newest home owner who outbid two other offers at more than the asking price: *And thanks to her real estate agent, who advised her to "step up to the plate" with a \$605,000 no-contingency bid, her cellphone was soon abuzz with good news. "Financially, I felt like I was out of my mind," the part-time medical technician said of her winning bid. "But I knew it would pay off because it's Boulder. I see it appreciating."* Then there was Ray Daneshi who bought just outside the Magic Kingdom in Orlando. *"We will not be going to any movies or eating out at restaurants," he stated, after buying a \$360,000 house with a mortgage equal to 100% of the sales price and 600% of his annual income. "But in two years, the house will be worth a lot more and we will have something to show for it."*

Fear not Ray—as they say, they're not making any more land, and besides, the Fed has backed up your purchase with their decree. On second thought, weren't they the ones who said they couldn't recognize the stock market bubble until after it popped? And on third thought, aren't Japan's housing prices still on average 50 percent below 1992 peak prices, even though they have approximately half the population of the U.S. squeezed onto a landmass the size of California? Didn't their real estate market continue to climb

for several years in a low interest rate environment after their stock bubble popped in 1990? Oh, never mind. Besides, those forward thinking folks in Congress are going to help us all get there anyway.

“Federally-insured” really means taxpayer-insured, as taxpayers like you foot the bill for defaults. So while Congress congratulates itself on yet another program that supposedly helps the poor, it is taxpayers who pay for the inevitable defaults. Nobody in Washington thinks twice about another welfare scheme that further entrenches the something-for-nothing mentality so prevalent today in America.

Dr. Ron Paul, Congressman from Texas

The “Zero Downpayment Act” Congressman Paul refers to creates a federal program that allows some homebuyers to obtain federally-insured mortgages without making a down payment. When I was a bank auditor, most credit analysts I knew realized that down payments tended to greatly increase the probability that a buyer would pay the mortgage. The loss of a down payment you scraped by for years to save can be a large incentive to pay one’s mortgage. I guess I’d better get with the times!

It’s the policies stupid!

I’ve commented previously on my disdain for all things political and how each side grossly skews things to its side, especially the economy. With the political games heating up, the spin-doctors from both camps are manipulating every economic statistic they can lay their greedy paws on—usually contradicting one another. But as usual, the truth lies somewhere in between. David Wessel recently wrote in the Capital section of the *Wall Street Journal* an article commenting, “Presidents get too much blame and credit for some things and too little scrutiny for others.” Let’s all face it, the guy who currently resides in the White House has little effect on the economy in the short term. However, as Mr. Wessel points out, “presidential economic policies do matter; it is just that the effects don’t show up for a decade, maybe even a generation.” He then suggests the three things that the next president can influence and that voters should ask:

- How will the U.S. reduce the federal deficit and prepare for the approaching, costly retirement of the baby boomers?
- How can federal leverage improve public schools and put college within reach of more Americans?
- What will the federal government, the largest purchaser of healthcare, do to make sure all (or nearly all) Americans get the most value for health-care dollars with the least waste?

Let’s see if either candidate answers these questions over the next few months or if they simply continue wasting millions of dollars mudslinging.

Pining for those Nostalgic Reagan years!

Larry Kudlow, a neo-economist, has written a remarkable article explaining why “this Bush Boom is a lot like the Reagan Boom 20 Years Ago.” They are similar, we reply, but only in the same way that, say, Uma Thurman, stark naked, is a lot like Dick Cheney in a negligee.

Bill Bonner, Author and Newsletter writer

Why is it when someone dies, we extol the qualities of them ad nauseam? The passing of Ronald Reagan was indeed a sad day, as he brought our country optimism when it was in dire need, and above all, he seemed like a nice guy. But if you read every article and listened to every talk show over that two-week period, you would have thought he should replace Washington on the dollar bill (actually, some tried unsuccessfully for the \$10 bill). As with all presidents, he did some good things and some not-so-good things, but it would seem that he will be remembered more for his style, as opposed to policies. He cut taxes, then raised them, brought supply-side economics to the forefront to stimulate the economy at the cost of increasing the annual federal deficit from 2.7% to 5.2% of GDP, broke the Soviet Union's back but left a national debt of some \$2 trillion dollars (a lot of money back then!).

As Mr. Bonner so eloquently points out, Bush is not Reagan and today is much different from the beginning of the 80's. Let's take a look, shall we:

	<u>Then</u>	<u>Now</u>
Interest rates	High	Low
Inflation	High	Low
Price of gold/commodities	High	Low
Stocks	Cheap	Fairly valued, if not over valued
America, world's biggest	Creditor	Debtor
Trade balance	Positive	Negative
American's debt balances	Relatively Low	High
American's savings rate	~9%	~1.5% (if any)

Wow, Larry, you're right— they're like mirror images! Reality is that the bull market that followed from the Reagan years through Clinton was predominantly the result of falling interest rates (10-year yields were pushed to 15.84% in September 1981) and easy access to the credit markets. My concern today is that the current ingredients needed for a new bull market don't seem to exist, because two of the more important factors, interest rates and inflation, are now reversing trend.

Spoiled Americans

"The days of enjoying privileged economic status because you were born American are over."

CEO Carly Fiorina addressing Hewlett-Packard shareholders

It always amazes me that not a chirp can be heard from the public when Congress spends our tax dollar billions on programs like those found in the 2004 budget such as \$2.7 million for the Wood Education and Resource Center in West Virginia, \$2.2 million for North Pole, Alaska (pop. 1,570), \$3 million for the First Tee Program in St. Augustine, Florida, \$1.7 million for the International Fertilizer Development Center headquartered in Muscle Shoals, Alabama, and my personal fave—\$50 million for an indoor rainforest project in Coralville, Iowa. However, raise peoples' gasoline prices by 50 cents and there will be more profanity thrown Washington's way than Vice President Dick Chaney could expound in a day. If paying an extra \$25 a month at the pump is going to throw people over the financial cliff, and the possibility of paying higher gas prices never crossed their minds before signing the lease on their new 5,000 pound Ford Explorer, then we are in more trouble than I fear.

"I confess that in America I saw more than America; I sought there the image of democracy itself, with its inclinations, its character, its prejudices, and its passions, in order to learn what we have to fear or hope about its progress."

Alexis de Toqueville, beginning his visit to America in 1831

(Warning! Steve's getting up on his Ivory Soap crate!) Mr. Toqueville left America feeling he had seen something truly unique, a country with all the elements of greatness. Today, we are not only experiencing a depreciation of the dollar, but also of values, it would seem. Does the popularity of reality TV; the ease with which consumers leverage their household debt like a personal hedge fund; the fact that states, desperate for revenues, are popping up gaming casinos faster than Starbuck franchises; the acceptance of Wall Street scandals and rise in school exam cheating; not to mention the sexual assaults in our military academies, depict a country in moral decay? Responsibility?— Nah. Even though countless individuals had pointed out the ridiculous multiples Krispy Kreme Doughnuts, Inc. traded at and the fact that they couldn't keep this type of growth going forever, shareholders still scarfed down the stock faster than the doughnuts. However, soon after the company recently announced that the low-carb diet trend has hurt sales, their shareholders did what any red-blooded Americans would and filed a lawsuit alleging it misled investors. After all, who could have foreseen that a low-carb diet sweeping the country would have a bad effect on a company that sells fatty, high-carb doughnuts? I wonder what Mr. Toqueville would say if visiting America today.

Portfolio Happenings

"Perhaps standing apart from the crowd, as value investing requires, makes people feel as though they, and not just their investments, are out-of-favor. Perhaps holding cash for what seems like forever, awaiting the emergence of an investment opportunity, is simply too emotionally difficult for them. Maybe exposure to criticism or second-guessing as a result of standing apart from the crowd is more than they can comfortably bear. Maybe it is the continued price erosion one can experience from buying corporate misfits and rejects - the relentless drain of out-of-favor securities continuing to melt away - that turns investors off. Perhaps it is hard to sound cool or even sane at cocktail parties when you don't own the hottest IPOs, and when no one has heard of the unpopular and obscure holdings that comprise your net worth."

- from Baupost Limited Partnership's 2003 annual letter, by Seth Klarman

Like the guests who suddenly realize they have overstayed their welcome, we continue our walk towards the door and our transition to a more defensive investment posture. The majority of index funds has been eliminated from our portfolios, as the market's risks seem to overwhelm the potential rewards. The cash level for most clients is at its highest since I've been at TWC, and the equity range is near the lowest percentage allowed by investment policy statements. Speaking of cash levels, another one of our managers, Southeastern Asset Managers, has recently announced they are closing the door on their Longleaf Partners fund, as they are having "difficulty finding companies that meet its investment criteria".

"Every form of refuge has its price."

Lyin' Eyes, Eagles

Although the domestic equity markets eked out a small gain for the quarter, many clients experienced a small loss after a good first quarter, as many of the hedges/investments we

sought refuge in reversed trend. Our exposure to the energy markets helped but could not offset the decline in the emerging, REIT, and commodities markets. Translation: the cigarette boat closed some of the distance on us during the quarter, as our “real asset” holdings (especially gold) weighed us down in tranquil waters. Most investment commentators expect commodities to continue trending downward and for energy prices to decline. I obviously disagree and expect, even if energy prices decline in the short term, the long-term trend is still up. Furthermore, we will not be jettisoning our commodities and gold holdings overboard just yet, as I continue to believe they will come in handy in the journey ahead.

Going into 2005

“Optimism is an extraordinarily powerful tool for personal growth and mental health. But it is not an appropriate philosophy of life. As a blind doctrine, it can leave a person vulnerable to many unnecessary pitfalls and even disaster. This is particularly true in investing. Stock market bubbles form when extreme optimism becomes a widely-held doctrine and blinds people to reality. Investing should be neither optimistic nor pessimistic, just realistic. And sometimes reality just sucks.”

George J. Paulos, Newsletter writer

“We are moving into a sweet spot for the economy, with interest rates not too high, jobs coming back and business investment providing strength.”

Diane Swonk, chief economist at BankOne

I included Diane’s quote just so you didn’t think everyone out there is a sourpuss. Actually, most economists, which I do not pretend to be, see nothing but clear sailing ahead. The Bond Market Association's economic advisory committee expects the strongest annual growth since Reagan was running for re-election in 1984. Many believe that last month’s high inflation number is unsustainable, and that, last month’s employment number aside, jobs will be coming out of the woodwork going forward.

Me, I’ve got a knot in the pit of my stomach similar to the feeling you get with only a half-hour left in a cliffhanger movie. Once into 2005, with the stimulus from tax refunds gone and Easy Al’s low-rate saloon long closed, we will see if the economy can stand on its own. My gut believes the economy is not performing as well as people think. There are already signs that things may be slowing down with recent reports from Wal-Mart, Target, General Motors and Washington Mutual casting a dark cloud on the horizon. Until my tummy is at ease or it becomes blatantly obvious that my concerns are unwarranted, we shall remain hunkered down in our Boston Whaler, while those around us continue their blithe samba around the chairs. I concur with analyst Dan Denning’s recent advice, "Recognize that the world is built on randomness and your financial security with it...why not take Pascal's wager instead...hoping you're wrong, but hedging your bets in case you're right?"

So pass the popcorn and hunch down in your seats—you just never know how these things end.

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