



Commentary

by Steve Henningsen

October 2005

Things are going great, and they're only getting better
I'm doing all right, getting good grades
The future's so bright
I gotta wear shades, I gotta wear shades
Lyrics to *The Future's So Bright I Gotta Wear Shades*, Timbuk3

I tried and failed! One of my associates suggested a few months back that I write a more, how should I say, *sanguine* commentary. Well, after rummaging through my desk drawer, I found my rose-colored glasses and dusted them off. I put on my happy hat and gazed out my office window at the beauty of the Flatiron Mountains of Boulder, hoping for some inspiration. Unfortunately, a front was moving in and the clouds engulfed my panoramic view and instilled writer's block. Oh well, I tried. Besides, it's so much easier writing without the glasses on.

Who wudda thunk?

*"The most important things to hear
are the things we don't want to listen to."*
Dr. Mardy's *Quotes of the Week*

"I don't think anyone anticipated the breach of the levees."
President Bush on the *Good Morning America* show

Buzz! Wrong answer Mr. President. Many have anticipated this event over say, the last century, but their concerns fell upon deaf ears. (We humans have a way of ignoring the past and focusing on the future—unless it involves the stock market.) Scientists have written about the dangers of New Orleans' location and how the inhabitants have made it a more dangerous place to live through years of development. The *Wall Street Journal* quoted Professor Theodore Steinberg, an environmental historian at Case Western Reserve University, as saying about Katrina, "*This is an unnatural disaster if ever there was one, not an act of God.*" The article also pointed out another professor's concern that the temporary lull in hurricane activity in Florida, from 1969 to 1989, spurred a reckless building boom of billions of dollars worth of condos within reach of storm surges.

Should the damage be such a surprise, when over 1 million acres of barrier islands and cypress trees, the very things that have provided a protective buffer to this fragile ecosystem in past centuries, have been removed over the past 70 years for the sake of development? Should the impact on energy be a shocker when the majority of oil refiners are located within the Gulf region?

"It's going to cost whatever it costs."
President Bush

"Can the country afford to rebuild in this high-risk area, where there is no means of mitigating the losses?"
Eric Tolbert, who until February was FEMA's disaster response chief

I say no. Now, don't take me as insensitive, as I am all for helping the people of New Orleans get back on their feet. However, before we dole out \$200 billion dollars of taxpayer money this country doesn't have and send it to one of the most politically corrupt areas in the country, shouldn't we be thinking what its best use would be? Haven't we learned our lesson in the past regarding trying to control Mother Nature? My six-year-old son can tell you that when you build a city below sea level, between two large bodies of water, in a hurricane zone, you might get soggy feet some day. So while Americans may emotionally wish to rebuild New Orleans, might it not be in everyone's best economic interest to only rebuild that part of it that is at low risk of flooding and relocate the rest?

When the government imposes its priorities it alters the balance of the choices which the individual can make for himself...His sense of responsibility for what he is not allowed to decide for himself is likely to diminish...
~ H.B. Acton

And while we have our thinking caps on, why not get rid of the perpetual government bailout called flood insurance that entices citizens to build in flood zones all over the country? If private insurance companies aren't willing to take on the insurance risk, why should our government step in to offer cheap insurance with our tax dollars? We are fortunate to live in a beautiful country and people should generally be allowed to live where they wish, whether it be on the mudslide- and earthquake-prone slopes of LA, within the forest-fire-prone areas of the Rocky Mountains or on the floodplains along the Mississippi. In my opinion, though, people who choose to live in high-risk areas (myself included) should be willing and able to cover their losses should Mother Nature come knocking.

US economy's parallel to Katrina

Engineers will tell you that the stability of a house depends upon its foundation. Build upon a poor foundation and, even though the house may look nice, time will likely catch up with you. The folks who lived along the Gulf Coast knew the risks of living within a hurricane belt. But the fact that the past several decades have been a statistical anomaly (fewer hurricanes than normal) combined with the moral hazards put in place through government programs (discussed previously) led people to develop a false sense of security. Sometimes it does not matter whether or not you have a strong foundation, but rather where you choose to build your home. For the folks in New Orleans, time caught up to them.

"If you had asked me, years ago, I would have said that the combination of war, record deficits and the largest public debt in the country's history would constitute a sufficient perfect storm to break us out of this spending addiction – and I would have been wrong."
Arizona Sen. John McCain quoted in the *Denver Post*



The US economy, while it appears to the world as a beautiful Victorian home, is on a weak foundation. The national debt is out of control; the President has yet to veto a spending bill; and Congress is too busy to care, making sure they bring home the bacon to their own constituents from the \$25 billion dollar highway spending bill. They're chipping away at the cement pillars of our economy's foundation without regard to the structure above it. (By the way,

the fact that this spending bill had 6,371 earmarks [read “pork barrel spending”] with hardly a grumble from the citizenry was disheartening to say the least.) Alaska took top honors by walking away with \$1 billion of the spoils and—get this—\$315 million of it will go to pay for a one-mile, 200-foot-tall bridge to connect a town of 8,000 to an island of **50** people. Another quarter billion will go to build a bridge near Anchorage to be named “Don Young’s Way,” after Alaska’s congressional representative responsible for the looting! Hey, he earned it.

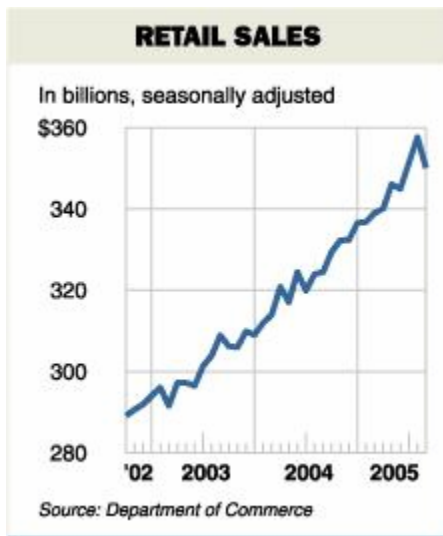
Now with the costs of the hurricanes mounting, you would think that it’s time to tighten Uncle Sam’s belt, but instead he will be letting it out a few notches. President Bush showed up at the steps of Congress with the first hurricane assistance bill to be paid, but no spending offsets to go with it. Have no doubt: *We as a country cannot afford to continue tax-cuts while increasing spending.* American politicians have been practicing the Roman tradition of bread and circuses for too long, and while the economy has muddled through so far, I believe our house of cards is teetering and in desperate need of shoring up.

Finally, relief for those poor energy companies.

Speaking of spending bills, your tireless congressmen were busy putting through an energy bill prior to grabbing their boogie boards and heading to the beach for their summer vacation. According to the *Washington Times*, “The vast majority of the tax breaks would benefit companies that produce and supply traditional forms of energy, with a large portion going to the oil and natural gas sector.” Well, I guess it makes sense—those who bestowed the biggest gifts (a.k.a. donations) upon the congressmen should reap the largest rewards. The bill also brought a nervous twitch to the ears of caribou, as the long-time moratorium on oil and gas drilling in the Arctic National Wildlife Refuge may be coming to a close.

Howling into the Void

“The world is not given to us by our parents. It is loaned to us by our children.”
Panel at the Biodiversity Hall of the NY Museum of Natural History



I’ve been concerned about the spending habits of my fellow Americans for as long as I’ve been writing these commentaries and feel a bit like the boy who cried wolf. However, with interest rates and debt levels on the rise and personal incomes and consumer confidence declining, only time will tell whether the dip on this chart is the beginning of a slow down or just a hiccup. The fact that 70% of our economy is dependant upon consumer spending and that consumers are now in negative spending territory (meaning they have to borrow to consume) surely doesn’t instill much hope in the world’s main engine of global growth.

Since Katrina’s and Rita’s one-two punch, the consumer is staggering like an aged prizefighter. Will winter’s projected high energy bills and banks’ higher monthly minimums due on credit card balances (thanks to a new Fed ruling) be the body blow that sends consumers to the mat?

Making it harder for future generations to compete

We let the families of the victims of 9/11 redesign our intelligence organizations, and our president and Congress held a midnight session about the health care of one woman, Terri Schiavo, while ignoring the health crisis of 40 million uninsured. Our economy seems to be fueled lately by either suing each other or selling each other houses. Our government launched a war in Iraq without any real plan for the morning after, and it cut taxes in the middle of that war, ensuring that future generations would get the bill.

Thomas L. Friedman, *New York Times*

My personal theory for a lot of what has gone wrong over the past few years is that ideology (i.e., Neo-Con) and faith-based belief systems (insert your choice here) have replaced elbow grease, deep thought, and long term strategizing as the methodology of implementing policy.

Barry Ritholtz, Investment Manager

Friedman and Ritholtz hit the nail right on the head! Not only will our children get stuck with the bill, but we are now placing obstacles in the path towards their future prosperity. Now, I do my best to tip-toe around any issues dealing with religion, but the controversy surrounding the belief in Creationism and Intelligent Design is too important to our economy and the future of our children to gloss over. America has achieved its level of affluence mainly through our understanding of science and investments in technology. There is nothing wrong with questioning theories—I, for one, am on record in past commentaries for questioning some of those in my own field. However, when we place these *beliefs* on the same mantel as *science* I get worried. Make no mistake, the universities in China and India are turning out over 600,000 engineers annually, and they are being taught *hard* science. Should this distraction to our children's school curricula continue, I believe it will only make our current fragile education system worse and develop children unprepared to compete in an increasingly competitive world.

Pass the buck!

In contrast, three large banks – which accounted for almost 40 percent of the respondents' residential mortgages outstanding – indicated that the share of nontraditional mortgage originations that had been securitized exceeded 75 percent.

Excerpt from US Gov't Senior Loan Officer Opinion Survey on Bank Lending Practices

What this paragraph means, dear taxpayer, is that the banks are passing on their less credit-worthy mortgage loans to the public through their securitization. (They are packaged and sold to mutual funds and pension funds.) Therefore, the banks will not be on the hook should defaults begin to increase, as that gap is reserved for shareholders and U.S. taxpayers.

U.S. automakers still don't get it!

American and Japanese cars of the 70's:



American and Japanese cars today:

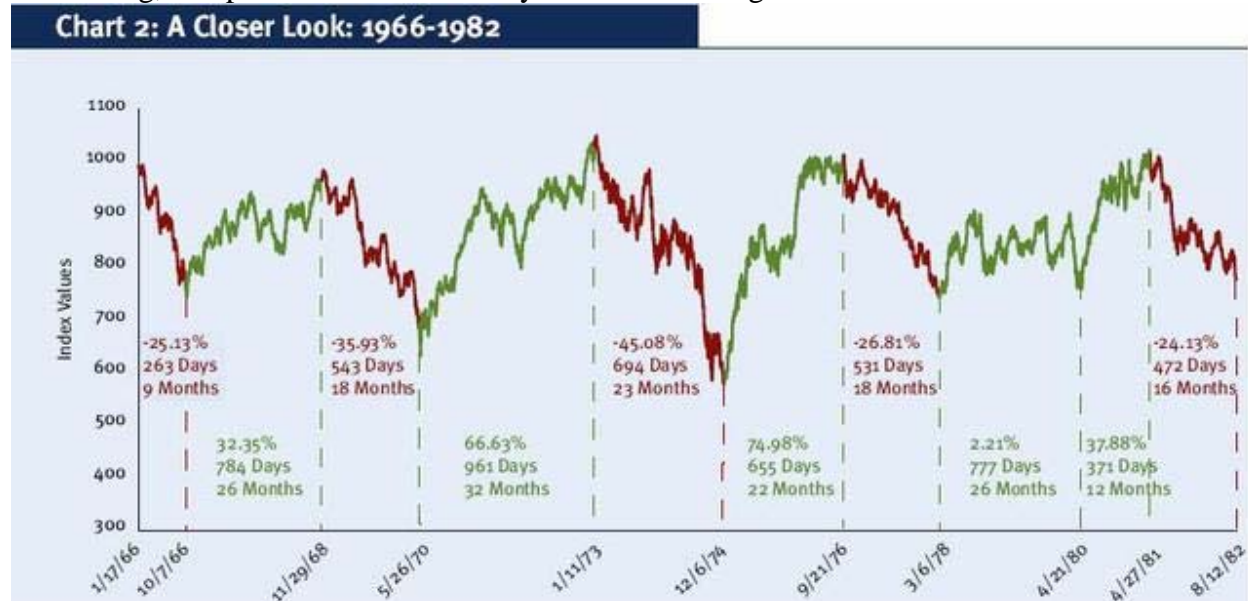


Is it any wonder that the Japanese automobile companies continue to eat our lunch?

Continuing with long-term perspectives

I've discussed market trends and valuations before, as there tend to be short-term *cyclical* trends that exist within long-term *secular* cycles (15-20 year periods where the markets are in a long-term secular upswing and others where they trend downward.) After WWI, stocks ran up to their 1929 high before they crashed and muddled through until WWII. Then another up cycle began through 1965. Beginning in 1966 stock prices spent the next 16 years treading water until 1982. Then *Business Week* magazine famously published "The Death of Equities," on its cover, and so began an 18-year bull market. The important point is that all of these long-term secular bull market cycles began from a valuation point in the stock market, as measured by the P/E ratio (price/earnings), somewhere south of 10. We are currently valued somewhere around 18 to 20, depending upon whose numbers you trust. Without the same ingredients, one cannot expect to end up with the same tasty dish. Therefore, I believe it unlikely we are about to begin another long-term bull market.

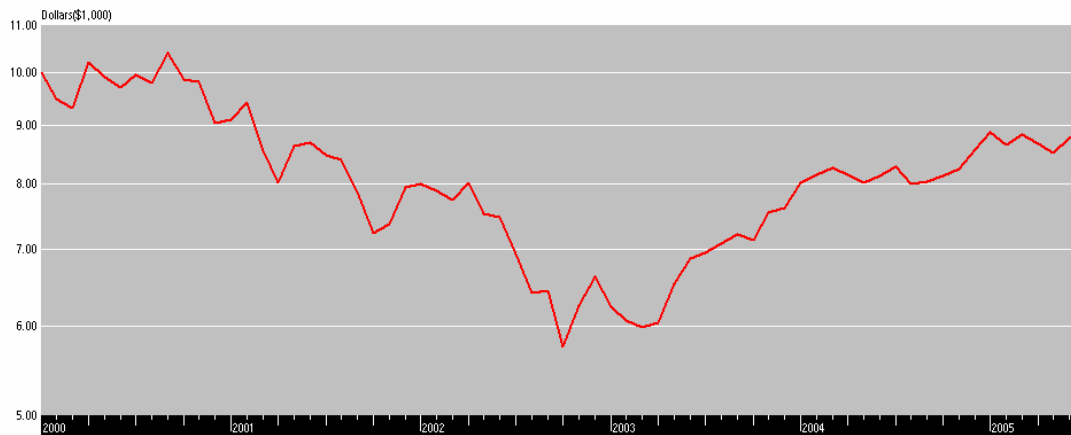
Now there is no reason to fret—this is simply the way stock markets work. But as shown on the following chart, put together by the folks at Rydex Mutual fund group using data from Bloomberg, it is possible to make money within these long-term trends.



What it shows is that there are times when being a buy-and-hold (a.k.a. broad-based index funds) investor doesn't work. However, in this time span there are several periods of big increases and decreases. As stated earlier, the buy-and-hold philosophy only works when one buys at a period when the markets are trading at a low valuation, such as 1982, and holds on through thick and thin until the cycle is over. Unfortunately, not many had the will to invest after getting beaten up throughout the 70's. Much of our current investment strategy rests upon the belief that we are currently in one of these long-term, flat-to-downward cycles, and this is one of the reasons TWC moved away from broad-based index funds a few years back. (Although, I do believe we are in a bull market cycle in commodities.) As the following Morningstar chart shows, even with the last two years' positive returns, investors have still not broken even since the beginning of the new millennium.

Growth of \$10,000: from 01-01-2000 to 06-30-2005

Fund/Index	Total Return %	Annualized Return %	Amount at End of Period \$
Vanguard 500 Index	-12.13	-2.32	8,787



Portfolio happenings

“Bulls always have been more popular in this country because optimism is so strong a part of our heritage. Still, over-optimism is capable of doing more damage than pessimism since caution tends to be thrown aside. To enjoy the advantages of a free market, one must have both buyers and sellers, both bulls and bears. A market without bears would be like a nation without a free press. There would be no one to criticize and restrain the false optimism that always leads to disaster.”

Bernard Baruch, American financier

Well, baseball fans, my last commentary reported Dallas Federal Reserve President, Richard Fisher, stating we were in the bottom of the eighth inning regarding interest rate hikes. It now appears he believes we are going extra innings. Evidently, the inflation dragon that the government has tried to hide is poking his head out while the knights of the Fed-table try to beat it back through higher interest rates. Unfortunately, the dragon is already out of the cave, and higher interest rates might have the adverse effect of bringing the villagers’ houses down upon their heads.

Thus far our caution regarding the stock market has not hurt us in 2005. As a matter of fact, we have performed rather swimmingly year-to-date and over the past several years, thanks in large part to our energy and commodities exposure. As Sting once sang, *“When the world is running down, you make the best of what’s still around,”* and oil, natural gas and gold are still around, just at higher prices. That’s not to say I’ve pulled all the right levers, a case in point being that I sold our emerging markets positions after their spring downturn, only to watch them “emerge” again in the 3rd quarter. However, I have no regrets, and I still feel the risks outweigh the rewards for now.

Speaking about energy stocks, one of the stalwarts in our portfolios has been Vanguard Energy. After almost doubling in value over the past 18 months, I decided this past quarter to take some gains and reallocate the proceeds to another energy fund, albeit a more “feel-good” fund, called Powershare Wilderhill Clean Energy Fund. This exchange traded fund (ETF) invests in *“companies that focus on greener and generally renewable sources of energy and technologies*

facilitating cleaner energy." This is comprised of approximately 26 companies with technologies related to energy storage, rechargeable batteries, fuel cells, and geothermal and solar power. I have been interested in alternative energy stocks for a long time, but never quite felt the time was right for investment. Now, with the long-term problems associated with traditional energy sources, I feel more comfortable with this addition to our portfolio. Keep in mind that stocks in this sector are extremely volatile, and we will be holding on for the ride!

Oh, I know I'm paid and paid well to shroud the *Outlook* with pessimism whereas equity, hedge fund, and these days private equity managers are paid and paid well to cast a perpetual glow of hope on tomorrow's dawning. But in determining whether or not the sun is rising or beginning to set on our economy and its markets, perhaps it is best to return to the maestro himself [Alan Greenspan] for a hint on the timing of this affair. "*Any onset of increased investor caution,*" he wrote at Jackson Hole, "*elevates risk premiums and, as a consequence, lowers asset values and promotes the liquidation of the debt that supported higher prices. This is the reason that history has not dealt kindly with the aftermath of protracted periods of low risk premiums.*" The secret for successful future strategies, therefore, may be to decipher what precipitates that increased investor caution and when.

From Bill Gross's *Outlook*

Now I am not going to gloat about this quarter's performance because I realize that, should the energy and commodity sectors reverse trend in the fourth quarter (highly probable), we could easily give up those gains. I also realize that I'm in the minority in that most other investment advisors are relying upon a repeat of last year's positive fourth-quarter stock market performance going into this year's final quarter.

Unlike Bill Gross or his equity counterparts, I am paid neither to be optimistic nor pessimistic, but to conserve and grow our clients' wealth based upon a pragmatic view. Granted, this view is difficult to anchor oneself to, as the shifting winds of optimism and pessimism blow incessantly. Alan Greenspan's warning may prove prophetic again, yet, ironically, I believe history will write him as the lead inciter of consumers' debt levels. As to the part about *when*, over two years ago I wrote of the gathering storm clouds on the horizon. My best weather guess is that those clouds are moving our way and will be overhead sometime in 2006. My belief is that our portfolios are positioned to weather the storm and that our investments in gold may give us some needed ballast. ☺

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