



**Commentary**  
by Steve Henningsen  
April 2006

*"When the facts change, I change my mind."*

John Maynard Keynes, British Economist

I would say, "when the facts become obvious," as, after I proclaimed in my last commentary that I would no longer be writing my typical dissertations, many of you called and emailed asking me to change my mind. I was rather taken aback, as I was never quite sure how many of you actually read them or even cared that I wrote them. Obviously, if clients see a value in my writings—even if they don't always agree with my opinions—I will continue to keep it up until I either have nothing left to relay or the emails and phone calls swing the other way.

**More of the same.**

*"The willingness of the Chinese to forfeit their own domestic monetary policy and finance our consumption at low rates is by definition unsustainable ... Deflationary pressures from Chinese labor have been neatly offset by rising raw material prices, and declining savings rates in the U.S. have been met by the willingness of private Chinese to save at even near 0% interest rates. If anything interrupts these delicate balances, the eventual corrections will play out quickly." ... "As the pressures build, the markets are lulled by the artificial calm that the cross currents have caused. As a general rule, global financial markets are expecting and pricing in extremely low volatility." ... "While knowing exactly where future volatility is headed is a very difficult thing, today we have a combination of very low volatility priced into markets with a set of underlying conditions that don't look nearly as stable, and this is a significant concern for financial assets right now."*

Bridgewater Associates

I don't have much to add here as Bridgewater does a great job of summing it all up. Conditions in China remain the same, but under increasing stress. There lies the dilemma for folks like me: expose clients to the fun of the party by being invested more in stocks or choose to sit on the sidelines for the *possibility* that something may happen?

**Robbing Peter to pay Paul**

*"Sooner or later in life, we all sit down to a banquet of consequences."*

Robert Louis Stevenson, Scottish Novelist

*"In my view, the greatest threat to America's future isn't a new superpower or even persons hiding in a cave somewhere in Afghanistan or Pakistan. Instead, this threat is widespread, involving U.S. policymakers, the public, and even the press. What I'm talking about is a decline in societal values and political comity, combined with continuing ignorance and inaction on a range of known issues that are rapidly reshaping the United States and the world. I'm talking about known forces like changing demographics and global economic trends that are having an impact on a scale not seen since the Industrial Revolution. Unfortunately, these and other current and emerging challenges are getting too little attention, provoking too little concern, and prompting too little action."*

*"Today in America, both policymakers and the public need to face the facts, take a long-term perspective, and accept the need for dramatic reform and some shared sacrifice. After all, when our days on this earth are nearing an end, we should be able to look our children and our grandchildren*

*in the eye and say we did everything we could to pass on a community, a country, and a world that's better off and better positioned for their future."*

This peppy quote comes from our friend David Walker, whom I've quoted a few times in the past. I guess I feel that anytime the U.S.'s head auditor talks, people should listen. Unfortunately, he gave his recent speech at the London School of Economics, so I'm not sure many of the U.S. citizens to whom it was directed heard him.

Think of his speech as more of a cliff-note version of his rather lengthy annual report submitted to Congress and available to anyone with the stamina to read it, entitled *2005 Financial Report of the United States Government*. (You thought *my* stuff was dry.) It basically gives a comprehensive overview of the federal government's finances as if it were run like a business—*except, if it were a business, it would be bankrupt*. Since the government can print money on a whim, continuously raise its debt level (now approaching 9 TRILLION dollars) and is accountable to no one, there will be no bankruptcy filing. So, except for those things, it's just like your average business. Anyway, insomniacs, masochists or anyone wishing to squelch the chirping of the blue bird on one's shoulder can go to the government's website <http://www.fms.treas.gov/fr/> for the full 158-page report. ***Warning—those with weak hearts, eternal faith in our government or a predisposition to optimism should not—I repeat, not—read this report, nor my excerpts that follow!***

Since most of you are busy and probably already find my commentary pushes the limits of your financial attention span, I have extracted a few sections from the Government Accountability Office Comptroller General's Statement, which are included in the report beginning on page 31. The letter gives a nice summary of the report, and I have italicized what I find the more interesting points. The letter begins with what all good U.S. businesses usually sprinkle at the end of their reports—disclaimers:

- Material deficiencies in financial reporting (which also represent material weaknesses) and other limitations on the scope of our work resulted in conditions that, *for the ninth consecutive year, prevented us from expressing an opinion* on the federal government's consolidated financial statements.
- The federal government did not maintain effective internal control over financial reporting (including safeguarding assets) and compliance with significant laws and regulations as of September 30, 2005.

Three major impediments to our ability to render an opinion on the consolidated financial statements continued to be (1) serious financial management problems at the Department of Defense, (2) the federal government's inability to adequately account for and reconcile intragovernmental activity and balances between federal agencies, and (3) the federal government's ineffective process for preparing the consolidated financial statements. Moreover, as a result of the material deficiencies we found, readers are cautioned that amounts reported in the consolidated financial statements and related notes, certain information contained in the accompanying Management's Discussion and Analysis, and other financial management information that is taken from the same data sources as the consolidated financial statements, *may not be reliable*. Until the problems discussed in our audit report are adequately addressed, *they will continue to have adverse implications for the federal government and the taxpayers*, which are outlined in our report.

More troubling still, the federal government's financial condition and long-term fiscal outlook is *continuing to deteriorate*. While the fiscal year 2005 budget deficit was lower than 2004, it was still very high, especially given the impending retirement of the "baby boom" generation and rising health care costs. Importantly, the federal government's accrual based net operating cost increased to \$760 billion in fiscal year 2005 from \$616 billion in fiscal year 2004.

The current financial reporting model does not clearly and transparently show the wide range of responsibilities, programs, and activities that may either obligate the federal government to future spending or create an expectation for such spending. Thus, *it provides a potentially unrealistic and misleading picture of the federal government's overall performance, financial condition, and future fiscal outlook*. The federal government's gross debt in the consolidated financial statements was about \$8 trillion as of September 30, 2005. *This number excludes* such items as the gap between the present value of future promised and funded Social Security and Medicare benefits, veterans' health care, and a range of other liabilities (e.g., federal employee and veteran benefits payable), commitments, and contingencies that the federal government has pledged to support. Including these items, the federal government's fiscal exposures now total more than \$46 trillion, up from about \$20 trillion in 2000. This translates into a burden of about \$156,000 per American or approximately \$375,000 per full-time worker, up from \$72,000 and \$165,000 respectively, in 2000. These amounts do not include future costs resulting from Hurricane Katrina or the conflicts in Iraq and Afghanistan. *Continuing on this unsustainable path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security.*

The letter ends with this lighthearted statement:

*Addressing the nation's long-term fiscal imbalance constitutes a major transformational challenge that may take a generation or more to resolve. Given the size of the projected deficit, the U.S. government will not be able to grow its way out of this problem -- tough choices are required.*

Hugs and Kisses,  
David M. Walker, Comptroller General of the United States.

*Rise up this mornin',  
Smiled with the risin' sun,  
Three little birds  
Pitch by my doorstep  
Singin' sweet songs  
Of melodies pure and true,  
Sayin', "This is my message to you-ou-ou:"  
Singin': "Don't worry about a thing" - I won't worry!  
"Cause every little thing gonna be all right."*

Bob Marley, Three Little Birds

Now before you go off calling me a pessimist, downer or whatever makes you feel better, remember: I'm not making this stuff up and you should be worried. While members of Congress roam the halls humming Mr. Marley's song, their constituents should be marching on their state capitals to demand that prudent finance returns to our government. Instead, we seem to be caught up in what (in my opinion) are small issues; illegal aliens, protective tariffs, etc. This growing protectionism is a global phenomenon (witness France's recent demonstrations and the U.S.'s rejection of the Dubai port deal) and could spell trouble for global trade. As far as

wasting billions more to build a wall between Mexico and the U.S., I can't help but feel there is something that runs deeper with this issue. Could the land of plenty be finding its pantry rather sparse and no longer wishing to share with newcomers, legal or not? History shows that when natural resources become scarcer, love-thy-neighbor gets thrown out the door. This immigration issue seems more like a symptom than a cause of U.S. woes. Anyway, these issues are small potatoes and we should instead be focusing inward on the concerns brought up by Mr. Walker's report. Folks, there is smoke rising "from the redwood forest, to the gulf stream waters," and we need to speak out before Rome burns again!

### **Doubting Thomases are back!**

*"Maybe it is his age, his probable retirement or the mediocre performance of Berkshire Hathaway's shares in the past two years. Buffet's most recent predictions leave the impression that he is out of touch. He looks at new, innovative trends in the market and condemns them as dangerous because he may not understand them so well."*

Matthew Lynn, in the International Herald Tribune

Towards the end of the nineties, investors began questioning Warren Buffet's investment savvy as technology stocks took off and Warren decided to stay put on the train station platform. Well, we all know how that turned out. Again, I am beginning to read articles (mostly from clueless journalists) casting doubt upon the actions of Mr. Buffet. So he doesn't like derivatives because they are complex. I, myself, have yet to meet anyone with a complete understanding of them. They also chide him for losing millions in his bet against the dollar last year, but they don't mention the millions he made in 2004 on the same investment. As far as the dollar goes, although Buffet and many others were incorrect in its direction in 2005, the game is not over yet. My chips would be on Buffet to make these skeptics look foolish again in the not-too-distant future.

### **Welcome to the Capitalist Club!**

*Rising inequality and rising household financial burdens are the triggers. The debate is another factor that will shift China's priority from growth to non-growth issues, I believe.*

Andy Xie, Morgan Stanley analyst

As Mr. Xie points out, China's leaders are finding that their newfound capitalist ways come at a price. Basically, only a small part of their huge population has been benefiting from their economic prosperity. Lately, many of the 700 million rural workers inland have been protesting as the disparity between the haves and have-nots has grown as fast as China's ability to throw up a 10-million-person city.

We in the industrialized world (who wrote the book on capitalism and the economic disparity that comes with it) have dealt with this issue for over two centuries now. Unfortunately, we can't give China very much advice since our own divide has grown over time. According to my March issue of *Moneyweek Magazine*, in 1820, 20% of the world's people in the richest countries had three times the income of the poorest 20%. By 1960, they had 30 times more; by 1997, they had 74 times as much. Nearly three billion people live on less than \$2 a day and 1.3 billion live on under a \$1. Now I'm not advocating a "tax the rich" program or anything, but if this continues, it will get to a point where the poor demand change and they have the votes (or riot numbers in China) to get it.

### **Portfolio happenings!**

In March we parted with another dear old friend, the Dodge & Cox Stock Fund. The fund has served us well over the past several years and has been one of the best performing U.S. stock

funds over the past decade. Their management takes their fiduciary duty seriously, which is more than I can say for many other fund companies. *Why then, Steve, did you choose to liquidate the fund while they're at the top of their game?*

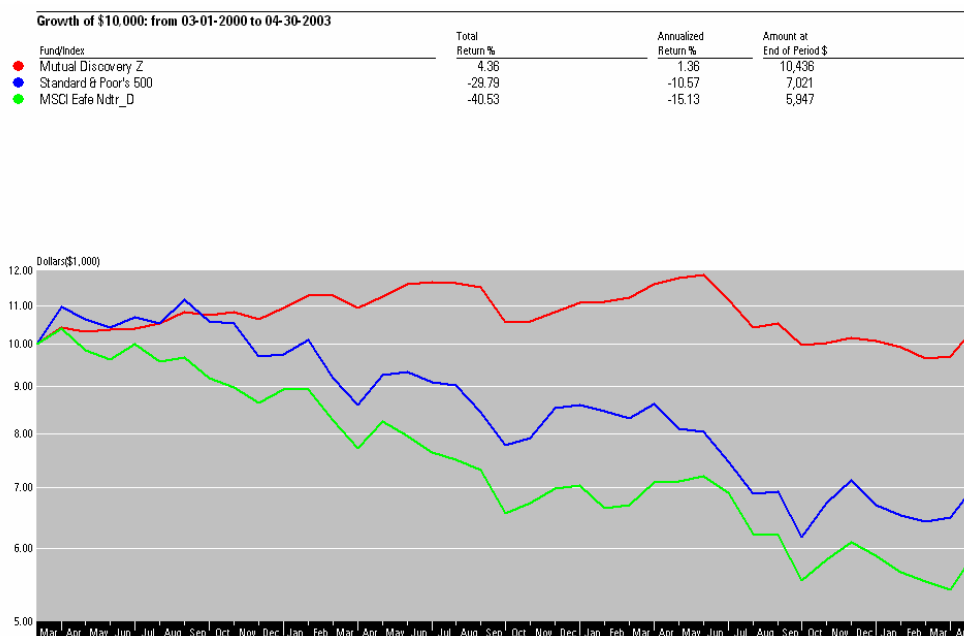
My decision basically came down to the size of their asset base, which is now north of 52 billion dollars. The majority of these dollars flowed into the fund over the last several years, before Dodge & Cox shut the fund to new investors about a year ago. As clients know, in 2003 I came to the conclusion that the investment environment over the next decade would look much different from that of the past 20-year bull market investors had come to enjoy. It would be one in which investors gained in one year and lost in another, yet over the decade they would end up flat or down in their U.S. stock market investments, much like the stock market environment of the 70's. It would not be an environment conducive to the buy-and-hold philosophy (a.k.a. index investments) and would favor active managers with "flexible" investment parameters. Thus began my investing in "flexible" managers such as Leuthold Core, First Eagle Global and Pimco All Asset.

Therefore, looking back over my shoulder, I could find no reason to liquidate Dodge & Cox Stock Fund. However, as I turn around and gaze towards the horizon, I find doubt that the 52 billion-dollar fund will have the nimbleness to steer through the choppy waters I envision ahead. I wish them luck, but would rather invest clients' money with a more adaptable manager. Fortunately, one has just become available.

### The Wintergreen Fund

*"If you look at the world as your playground for investing, there's always something out there."*  
David Winters

I have been a fan of David Winters for many years now. As chief investment officer at Franklin Mutual Advisors he developed one of the best performance track records in the industry. More importantly to your's truly, not only does he know how to compound money, but he knows how to preserve clients' money in down markets, as shown by the performance of one of the mutual funds he managed, Mutual Discovery Fund, during the 3-year period between 2000 and 2003.



What you might not know is that he also managed one of our holdings, Mutual Recovery Fund, up until the end of last year. I originally invested in this fund because of his management, the fund's flexible mandate and the fact that it had a much smaller asset base than the other billions he managed through the Franklin Mutual Advisors Funds. What you also might not know is that he left Franklin Mutual Advisors near the end of last year to strike off on his own.

His new fund is called the Wintergreen Fund and it has everything I like. These are a few quotes from his first shareholder letter:

*"Our goal is to be careful stewards of your capital by searching the world for compelling investments that have the characteristics of understandable risk with meaningful upside potential."*

*"...we opted for maximum flexibility with respect to our portfolio holdings..."* (He can invest in basically anything and may also "short" stocks.)

*"Since we do not seek to mimic an index, we expect that there may be periods of time when due to investment style and/or security selection, we find ourselves out of step with the markets."*  
(Join the club!)

The only thing not to like is the fund's high management fee which is currently 2%. However, this is a bargain when you consider he manages it like a hedge fund, which typically charges much more, and that this fee will come down as assets build in the fund. (He only has about \$275 million under management at the moment.) Besides, I feel he is one of the few investment managers worth it, meaning he can overcome the fee to deliver better than average results.

The other thing that caught my eye from his shareholders report was the poem he began it with. It was the same Robert Frost poem, *The Road Not Taken*, that I had mentioned in my 2<sup>nd</sup> quarter 2003 commentary when discussing the different path we were choosing going forward. Seems we have a fellow journeyman.

I will wait until this July to part ways with the Mutual Recovery Fund; by that time it will have been in most clients' portfolios for longer than 12 months and they can obtain the long-term capital gains tax rate.

### **Rising from the depths?**

Towards the end of 2003, I invested approximately 3% of clients' portfolios in the Profunds Rising Rates Opportunity Fund. (The fund shorts the U.S. 30-year Treasury bond.) I then went on to watch it lose 18% of its value through the end of 2005, as long-term yields actually dropped. I must admit that I almost pulled the plug on it last year, as there seemed to be no "opportunity" left in it. Before I did, I questioned why I had purchased it in the first place. I decided that since it was a *hedge* against rising interest rates and not a bet, that I would keep it. After all, as I have stated several times in the past, these hedges were put in place to reduce risk and not all would work at any one time.

Well, this past quarter our hedge paid off as long-term interest rates began to rise and the fund gained 10% to help offset some of the losses in our regular bond funds. I'm not sure what the road ahead looks like for interest rates, but it is nice to know our hedge worked when it should have.

## All things heavy!

*“Discretion will protect you,  
And understanding will guard you.*

Proverbs 2:11

As satisfied as I am that we gained >5% for the quarter, thanks again mainly to our precious metals and energy holdings, it was a good reminder of the volatility inherent in these investments. Three of our commodity-related funds gained over 15% in the month of January, before giving some back in February, while our Powershare Wilderhill Clean Energy Fund gained almost 30% for the quarter. These volatile swells are part of the journey, and I have no doubt that we shall experience the downside of the commodity markets' surge at some point along the way. We remain overweight in cash and underweight in the equity markets to help maintain our ballast.

I will close with another quote from David Winters:

*“In the mutual fund business, there are such pressures to conform to an index or an informal index, and no one wants you to hold cash. But there are times that cash is the best thing to have. You're much better off having cash than owning lousy, overvalued securities.”*