



Commentary  
by Steve Henningsen  
July 2008

### **The Great Unwinding!**

*But don't be fooled by the radio  
The TV or the magazines  
They show you photographs of how your life should be  
But they're just someone else's fantasy  
So if you think your life is complete confusion  
Because you never win the game  
Just remember that it's a Grand illusion  
And deep inside we're all the same.  
Styx, The Grand Illusion*

This quarter's commentary marks the 5<sup>th</sup> anniversary of my protracted writings and I am finding it the most difficult to write. I have an overwhelming feeling that many of the problems I've written and worried about over the years are beginning to materialize with real ramifications. (For those of you who haven't been along for the ride, my past commentaries are available on our website; [www.thewealthconservancy.com](http://www.thewealthconservancy.com) ) Yes, the "grand illusion" is beginning to fade as America wakes up to the dawning of the 21<sup>st</sup> century and the reality that appears through the light.

*"Justice does exist in the world, whether people choose to practice it or not.  
The men of ability are being avenged. The avenger is reality."  
—Ayn Rand*

You would think I would be in a more chipper mood given we made it through our 3<sup>rd</sup> consecutive positive quarterly performance against global stock markets in freefall and now stand, albeit wobbly, up around 5% year-to-date. Our performance is partially due to our focus on preservation of capital; in other words, our reluctance to step out onto the minefield, even as most of Wall Street yelled the coast was clear (a.k.a. "buy on the dips") and marched on (the medics are currently busy attending to their wounds). However, I don't pretend for a moment that I know what comes next. Nor do I believe that Lady Luck hasn't been sitting by our side for the past year and that I can prevent her from getting up and leaving without warning. These are truly humbling times, but as REO Speedwagon sings, "*We're riding the storm out, waiting for the fallout.*"

Unlike many in the investment world, though, I don't feel we are at the end of it. "It" being something big, something that when we look back in 20 years, we will say I remember when that happened—the power shift from West to East, the end of cheap energy and food, climate change or when Ph.D. capitalism blew up.

## Welcome to Detox Nation!

*“The humiliating pass to which we have been brought is nothing less than the culmination of long years of chronic, creeping inflation and the insidious erosion of personal liberty and individual responsibility to which it has contributed. This has left us with a financial sector into which has been poured too much investment, too much talent, too much influence and which has therefore become not a means to the end of greater material prosperity, but has become an end itself— and a distractive, often a destructive, one, at that.”*

– Sean Corrigan, investment manager

*“The great enemy of the truth is very often not the lie— deliberate, contrived and dishonest— but the myth, persistent, persuasive, and unrealistic. Belief in myths allows the comfort of opinion without the discomfort of thought.”*

– John F. Kennedy

Yes, we have arrived at the point in history called payback. We are beginning to experience the hangover from decades of our government’s and its citizens’ lack of *fiscal restraint*. It will not be measured in months, as the boob-tube financial charlatans want you to believe, but in years. It took years to get us in this mess and it will take years to get out. Our highly leveraged society will slowly have its built-up excesses wrung out of it, as government, corporations and consumers cleanse their balance sheets. Here’s a quick recap of the party—or, “How We Got Here”:

On our government’s side, politicians have destroyed our nation’s balance sheet by spending like drunken sailors, while lining their pockets with lobbyist dollars and pretending that deficits don’t matter. They took entitlement programs (i.e. Social Security, Medicare) and over 30 years, twisted, tortured and manipulated them into unfunded promises for their constituents, which can never be fully paid. They weakened sectors of our economy through over-regulation—typically closing the barn door long after the animal escaped—all the while turning a blind eye to the over-leveraged financial behemoths, Fannie Mae and Freddie Mac, growing silently in the dark. (On a side note, Treasury Secretary Paulson came out today to state that Fannie and Freddie were well capitalized, which these days means they’re toast!) Then they basically allowed the corporate world to take advantage of loose accounting rules to allow all sorts of “off-balance sheet” items to be kept in the drawer, while their CEOs held up to the markets their exemplary earning statement causing the CEOs’ stock options to pop. Moral hazard came to Wall Street as, through the government’s control of interest rates, they allowed investors to develop a false sense of security by coming to their rescue every time the stock market burped or—God forbid—the economy began to sputter and show signs of what old-school economists use to refer to as “the business cycle.” If this wasn’t enough, Uncle Sam got out his checkbook and started depositing “sweets” into our mailboxes to keep the sugar-high going. Few questioned the fact that we had to borrow the funds to pay for that candy (not to mention two wars that are going on which no one seems to notice). The consequences of all these actions over the years has been the slow death of our beloved currency, the dollar. Too bad there wasn’t anyone in congress with the guts to speak out about this...

*“The mistakes made with excessive credit at artificially low rates are huge, and the market is demanding a correction. This involves excessive debt, misdirected investments, over-investments, and all the other problems caused by the government when spending the money they should never have had. Foreign militarism, welfare handouts and \$80 trillion entitlement promises are all coming to an end. We don’t have the money or the wealth-creating capacity to catch up and care for all the needs that now exist because we rejected the market economy, sound money, selfreliance and the principles of liberty.”*

–Ron Paul, United States Congressmen

Our representatives should take Douglas Adams’ advice—*“When you blame others, you give up your power to change.”*

## **Fool Me Once, Shame on You...**

*"Some pretty intelligent people are now buying stocks... Unless we are to have a panic – which no one seriously believes - stocks have hit bottom."*

–R.W. McNeal, a market analyst writing in 1929

Then there is Wall Street. Anyone who has met me knows I have disdain for most of Wall Street, especially their marketing machines—the brokers. I have watched them for 20 years screw their clients, whether it's selling them proprietary junk products or leading them into the technology bubble buzz we saw in 2000. I often wondered out loud to colleagues how the Merrills, Goldmans, Lehmans of the world still had clients after all these years.

*Well you may throw your rock and hide your hand  
Workin' in the dark against your fellow man  
But as sure as God made black and white  
What's down in the dark will be brought to the light  
You can run on for a long time...  
Sooner or later God'll cut you down  
Johnny Cash, God's Gonna Cut You Down*

You can imagine my amusement at watching them drink their own poison over the past year. Their MBA, whiz-kid bartenders concocted Kamikaze drinks by taking several different risk liquors and mixing them together as dictated by their recipes/models. Once mixed together, they could not be separated, and looked rather harmless to most of their customers. However, Wall Street failed to remember a bartending rule: never drink what you're serving. Now these drinks, that they too consumed, have been shown to have the same properties as hemlock and have already taken out Bear Stearns. More firms will follow. My question is how can investors trust these firms with their money when the firms themselves can't even manage their own assets????

*Investors are well advised to assume greater responsibility for risk management in today's world where the conditions of yesterday are colliding with those of tomorrow.*

–Mohamed El-Erian, *When Markets Collide*

My guess at what Mr. El-Erian is saying (it's a good book, by the way) is to stop listening to the morons telling you to look in the rearview mirror as you drive down the road towards the cliff. There are times to buy and hold, average down, buy for the long run—yadda, yadda—but now ain't one of them. Turn around and look at what's coming down the road, as the road (world) is changing. Oh, and you might want to reduce your speed a bit.

## **And J. Q. Public Isn't Without Fault!**

*"Our destruction, should it come, will be from another quarter. From the inattention of the people to the concerns of their government, from their carelessness and negligence. I must confess that I do apprehend some danger. I fear that they may place too implicit a confidence in their public servants, and fail properly to scrutinize their conduct; that in this way they may be made the dupes of designing men, and become the instruments of their own undoing."*

–Daniel Webster, American statesman

We citizens aren't off the hook either. (We did vote these clowns in, didn't we?) Beginning in the 80's, we threw caution to the side and began leveraging our own balance sheets. Savings became something that "old-people" did as credit card applications started falling from the sky. A higher living standard was not something to work towards, but from, as one could quickly attain it through cheap debt and low monthly payments. Even the technology bubble wasn't enough to deter us, as we quickly switched over and began siphoning money from our houses. Real estate appreciation began spawning new cars, plasma TVs and trips to Vegas. All was good

while the appreciation outran the debt pyramid, as we fooled ourselves into believing that a house was an investment; a productive asset. *Ahh, but this type of thing hasn't happened before, Steve.*

*—You may think that since it was all a delusion on the profit side, the loss also must have been imaginary; that if nothing was added to the wealth of the country, neither was anything taken away. But that is not the way of it. First there was the direct loss of diverting that credit from all the possible uses of production to the unproductive use of speculation. Secondly, a great deal of it was consumed by two to three million speculators, large and small, who, with that rich feeling upon them, borrowed money on their paper profits and spent it. In this refinement of procedure what happens is that imaginary wealth is exchanged for real wealth; and real wealth is consumed by those who have produced nothing in place of it. Thirdly—and this was the terrific loss—the shock from the headlong fall of this pyramid caused all the sensitive sources and streams and waters of credit to contract in fear. The more they contracted the more fear there was, the more fear the more contraction, effect acting upon cause. The sequel was abominable pain.*

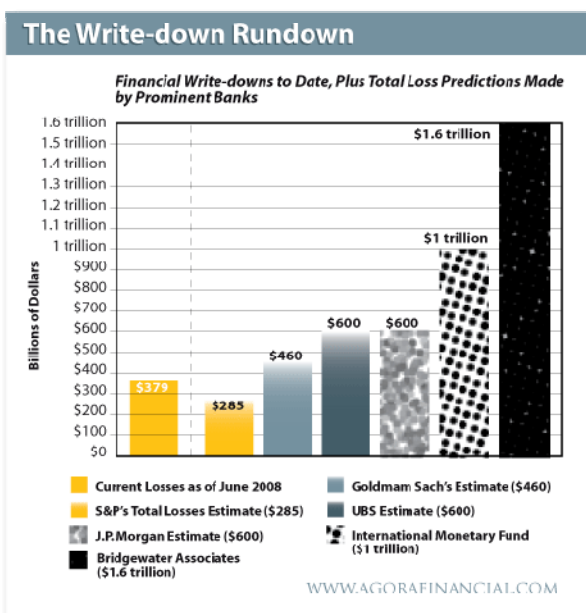
—Garet Garret, *The Bubble That Broke The World*, 1932

## Where Are We in This Mess?

*Yesterday,  
~~Love~~ Investing was such an easy game to play,  
 Now I need a place to hide away,  
 Oh, I believe in yesterday.  
 Beatles, Yesterday*

OK now that I am finished ranting for the moment, let's take a look at where we are in this mess. Now, let me be clear that because of the complexity of many of these financial derivatives and the fact that the banks and brokers are hiding them off their balance sheets, no one, *and I mean no one*, knows exactly where we are in this deleveraging process. Therefore, how long it will take before we can move the financial debris from the road and move on is anyone's guess. All we can do is sit back and watch the show as the banks and brokers continue the process of coming out on a Tuesday to calm their shareholders by declaring that they remain "well capitalized" only to step to the podium Wednesday morning to cheerfully welcome their newest Saudi shareholders who "recapitalized" them overnight. (Educational note to investors: when a company states that they were "recapitalized," it means your shares were diluted or, in other words, they hosed you!)

In order to really confuse investors, many companies, such as AIG, have even raised their dividends, while at the same time having to raise billions to "recapitalize." It, of course, makes no sense to raise ones dividends to shareholders while diluting them at the same time, but I'm sure AIG figured that something so blatantly illogical would float by its bewildered shareholders undetected.



I mentioned a while back that this mess would probably end up costing a trillion dollars by the time its over. What an optimistic fool I was. As you can see from this handy chart from the folks at Agora, we are currently at around \$400 billion in write-downs. (Educational note: when companies come out and declare a "write-down," it means that they have given up all *hope* that an asset they held on their balance sheet is worth what they marked it at.) As you can see S&P's estimate was way off (similar to

their AAA ratings) and the Wall Street wonder boys' estimates will be surpassed shortly. The one that really stands out is the one from the folks at Bridgewater Associates—*1.6 trillion*. (If that name rings a bell, it is because I have mentioned them and their founder Ray Dalio, many times in the past. They are some of the smartest financial guys I know, and I sit up straight any time they make a statement.) My money is on them as far as what the total cost will be in the end.



This “*Cycle of Market Emotions*” chart keeps popping up on various investment websites these days and I have shown it in the past as well. It is based upon The Kübler-Ross model (Five Stages of Grief) which describes the process by which people deal with grief and tragedy: Denial, Anger, Bargaining, Depression and Acceptance. Psychology works in the investment world as well, and most people I listen to seem to believe that we are somewhere between denial and fear. (If the markets crash, then you know we hit “panic.”) Given that we are a long way from deleveraging the financial system and that we are probably somewhere between denial and fear psychologically, it seems prudent to remain defensive for now.

(Now you have to indulge me for a second as I wind my way back to Congress for a minute.)

### Government to the Rescue!

*There is unrest in the forest,  
 There is trouble with the trees,  
 For the maples want more sunlight  
 And the oaks ignore their pleas...  
 So the maples formed a union  
 And demanded equal rights.  
 "The oaks are just too greedy;  
 We will make them give us light."  
 Now there's no more oak oppression,  
 For they passed a noble law,  
 And the trees are all kept equal  
 By hatchet, axe, and saw.  
 Rush, *The Trees**

Have our fearless congressmen awoken to our plight? Called an emergency meeting to discuss the housing crisis? Pulled an all-nighter to develop a type of “Manhattan Project” to solve our energy woes? No, they did what all good politicians do when a problem arises; they began to wag their fingers at others. As Robert Half once quipped, “*The search for someone to blame is always successful.*” First they tackled the housing problem by bringing Countrywide Financial’s CEO, Angelo “I Love the Sun” Mozilo, before them for a hearing. They used kid gloves on him, which was surprising until it came out later in the news that U.S. Senators Christopher Dodd and Kent Conrad received advantageous loan terms from Countrywide when applying for recent mortgages. *Portfolio* magazine reported that “*Dodd, who oversees the U.S. mortgage industry as*

chairman of the Senate Banking Committee, and Conrad, a North Dakota Democrat, received loans through Countrywide's "V.I.P." program, which waived points, fees and borrowing rules for prominent people." According to their spokesmen, "They did not seek or anticipate any special treatment and they were not aware of any." That's funny, because I too got a mortgage through Countrywide and don't remember the mortgage broker connecting me to Angelo's private line for the "VIP" program. Come to think of it, I wasn't even told they had one! That's what I love about politicians, you don't have to make anything up, they do it to themselves.

*"As Americans we must always remember that we all have a common enemy,  
an enemy that is dangerous, powerful, and relentless.  
I refer of course to the federal government."  
—Dave Barry, humor columnist*



Next, our caped crusaders moved onto solving the energy crisis, which they first tried to remedy by suing OPEC—what do you expect when most of them are lawyers! But after one of their high school staff members informed them that their congressional powers don't work outside U.S. borders and that they can't dictate oil prices internationally, they brought out "old reliable" and hauled a bunch of mean looking oil guys up before the cameras. (Hey, it fixed baseball's problems, right?) After informing the cable networks of their best facial shots, they began ripping into the evil oil men. *How dare you make money from products we need. We don't care that you almost went bankrupt in the 80's when oil was cheap and that your industry has some of the narrowest profit margins in any industry—(then, turning to the networks)—those cameras are still on, right? What was that comment, Mr. Darth Vader, CEO? Oh, well, so what if we limited your ability to drill offshore and haven't allowed a new oil refinery to be built in 25 years. (Psst, Page, can you have his mike shut off?) We also allowed our mass transit system to disintegrate, established no energy plan, failed to promote alternative energy development, stuck a knife in our nuclear program, maintained CAFÉ standards at laughable low levels, and instituted one of the biggest wastes of money and food in history through our ethanol program, but you don't see any of those industries whining, do you Mr. Big-shot CEO? (A quick wink to the Archer Daniels Midland lobbyist sitting in the front row.) Besides which, what does any of this have to do with cheaper oil? We're done with you oil guys, so please leave the room so we can bring in the vicious oil traders, I mean speculators, next. I won't get into how ridiculous blaming speculators is.*

*And the men who hold high places  
Must be the ones to start  
To mould a new reality  
Closer to the heart  
Rush, Closer to The Heart*

Too bad there wasn't some sort of global energy committee that Congress could listen to for advice...

*"Often it is a case of political expediency to find a scapegoat for higher prices, rather than undertake serious analysis or perhaps confront difficult decisions... Money flows and speculation can have a day-to-day influence on prices, but it is not one that can be sustained for any length of time without a market imbalance being apparent. The economy is impacted by fluctuations in spot oil prices, not futures prices...Blaming speculation is an easy solution which avoids taking the necessary steps to improve supply-side access and investment or to implement measures to improve energy efficiency."*

—Recent International Energy Agency report

## Portfolio Happenings

*“Capital is destroyed because thinking doesn’t change when paradigms do.”*

–Mark Lapolla, investment manager

There is a time and place for autopilot and a time to throw your long-term strategic investment policy to the side and grab the reins. This past year has obviously been the latter!

The speed of the market’s return to complacency after the Bear Stearns blow-up amazed me and added to my reasons to remain defensive. While most believe Bear Stearns was the equivalent of a tire blow-out (quick-fix), my belief is that it was simply the warning light flashing on our economy’s dashboard. It was a symptom, not a cause of problems beneath the hood.

Much of our ability to tread water while the markets have declined is due to our being underweight equities and overweight cash (which includes foreign currencies.) Our heavy exposure to commodities, including 10% to gold and silver bullion, has been a stabilizer, as has the outstanding performance of managers at Caldwell & Orkin and Pimco All Asset, All Authority and Prudent Bear, who fully utilized their ability to go “short” the market.

I have also been trying to limit the downside through the purchase of ETFs that “short” the market. I sold our ETF that shorts the Russell 2000 Index in March for a nice gain, as I anticipated that we may get a short-term rally. After I had thought that the rally was over in April, I proceeded to purchase an ETF that shorts the S&P 500 Index. The timing of these trades was lucky to say the least. I recognize that making short-term decisions like this isn’t the most tax-efficient way to manage portfolios, because the gains won’t qualify at the 15% long-term capital gain rate. However, in times like these, I would rather capture 70% of a gain, than be exposed to 100% of a downturn. I assume clients agree.

### **What I Expect from Our Managers!**

*“The cost . . . far exceeded our worst-case estimates of how much the historically prudent and conservative Swiss bank’s board permitted the investment bank to over-leverage its balance sheet with questionable assets...*

*Buying this stock last year was a mistake.”*

–Longleaf Partners management discussing UBS in their First Quarter Report

This isn’t to say that all areas of our portfolio performed well. The hardest thing to do in this business is to admit mistakes, but that is just what the managers at Longleaf did this past quarter. Most on Wall Street find this a sign of weakness and do everything they can to cover their asses. To me it is a sign of strength and increases my trust and faith in them. They have one of the best performance records in the industry and it is in large part because of how seriously they take their fiduciary duty, which includes knowing when you’re wrong.

On my own “kick-me” list is the fact that I was going to purchase a natural gas ETF back in December, as I felt it was “cheap” but I didn’t have the guts. It would now be up about 50%-ahhh! Speaking of energy, clients may have noticed that I recently sold our Vanguard Energy Fund position, which we have held and benefited tremendously from for five years. I have not given up on energy, but simply wish to switch horses in the middle of the race. Vanguard Energy is heavily weighted towards the integrated oil companies, such as Exxon, and I believe that going forward, energy service companies will perform better. (Much more exploration will be needed in the years ahead and the service companies will benefit, no matter what the price of oil.) Therefore, I will soon be investing directly in the service companies.

*But I kept on looking for a sign  
In the middle of the night  
But I couldn't see the light*  
Climax Blues Band, *Couldn't Get it Right*

Lately I have felt like Frodo Baggins from *The Lord of the Rings*, as the markets seem to be trying to draw me back in, calling to me. So much of the investment industry is based upon being fully invested that when you aren't, it feels uncomfortable. But I have, thankfully, resisted the urge for now, although I did recently add to some of our alternative energy holdings.

*"Throughout history, people have focused too little on the opportunities  
that problems present in investing and in life in general."*  
–Sir John Templeton, one of the best investors of all time

Mr. Templeton passed away recently and will be missed greatly by the investment world. I agree with his philosophy and look forward to re-entering some of the financial markets that we have stayed away from these past few years– Specifically, Asia and some of the other emerging markets. I might even be tempted to buy into the banks at some point, but for now, watching many of the investment managers walking around with bloody, bandaged hands from their attempts to catch the proverbial “*falling knife*” is enough to keep me sitting on mine. This is a time for patience, not heroes.

*Believe it or not, as cautious as I have been over the past 10 years, I am now the most cautious of my entire career.  
The Perfect Storm has indeed formed, but if I am wrong about all of this, and magically the market and economy  
and credit woes magically heal themselves, I will have lost opportunity, but not capital.*  
–Bennet Sedacca, Investment manager

Mr. Sedacca, I completely agree!