



**Commentary**  
by Steve Henningsen  
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*"You can swim all day in the Sea of Knowledge and still come out completely dry. Most people do."*  
—Norman Juster

Wipe the slate clean, put up the new calendar and start on all those New Year's resolutions you'll forget about in a few weeks—it's 2006! I wish everyone a healthy and prosperous year ahead, and going into the new year, I am making a change myself. This will be my last commentary in its current form. Now, please hold your applause and return to your seats. I have been writing these lengthy commentaries for a few years now, and feel the time is right for a shift in format. Going forward I will focus my quarterly commentary on portfolio matters, as opposed to my hodge-podge of opinions on various subjects and articles I've read. (This should also save a few trees each quarter.)

For those that are actually entertained by my ramblings, there is good news for you as well. I'm getting with the times and putting my thoughts onto our blog on our new website. For those of you unfamiliar with the word blog, it is short for weblog and is basically an online journal/newsletter, the writing of which now makes me a blogger. Many individuals and professionals have been creating their own—we are late to the game! This will allow me to post more timely comments, post web links to the various articles I discuss and even enable readers to write back comments concerning my comments. (Ahh, those two-way streets can be dangerous!)

However, for this commentary it's more of the usual.

**Get out your Pom Poms!**

*"The chief danger to our philosophy, apart from laziness and woolliness, is scholasticism... which is treating what is vague as if it were precise..."*

—F.P. Ramsey

I read countless articles and books in 2005 in an attempt to get a read on the horizon. As usual, my short-term vision stays blurred. The debates that I have written about over the years rage on: inflation vs. deflation, rising vs. falling dollar, yield curves, will the consumer finally be tapped out, will real estate collapse, will business finally begin to spend again, will energy prices continue to increase, will China's growth begin to slow, etc. Both sides of these debates make good points, but alas, I find myself still standing where I was at the beginning of 2005. It seems every investment professional states how pointless it is to make predictions, *prior to making them*, so here's my gut feeling for the year ahead: the economy will slow, due mainly to consumers finally easing their spending. Yes, I've been saying this for some time now, but higher interest rates on credit cards, home equity loans and interest-only mortgages will begin to take their toll. The dollar *should* revert to its downward trend, as Asia slows its support (have you noticed how many foreign governments have stated their wish to *diversify* their currency reserves?) Furthermore, I remain convinced risk outweighs reward. Tight credit spreads, low

mutual fund cash levels and a low VIX index measurement (a low VIX indicates trader confidence), are signs that investors are underestimating market risk and the slightest disappointment may make for rough times in the equity markets.

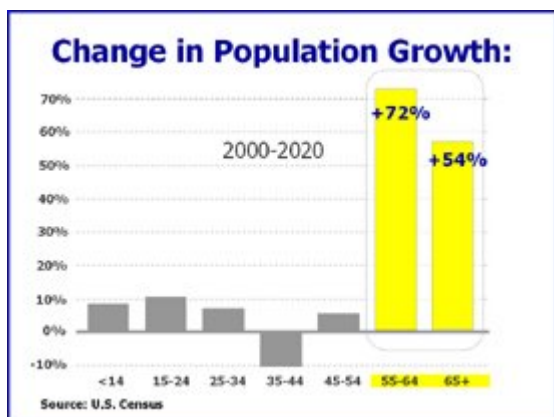
If it makes you feel any better, as usual I'm in the minority in my thinking as the consensus from Wall Street is for more of 2005 in 2006—basically, the economy continues to grow, inflation stays at bay, the dollar continues to gain strength, energy prices subside, China continues to support our spending habits, consumers hang in there, employment picks up, the housing market slows down but doesn't collapse and, lastly, the stock market rises.

So, there you have it—not much has changed in 12 months, and next January we can all look back at where we guessed wrong. I will take the remaining time to focus on what has been one of my bigger concerns over the years: future obligations; i.e., pensions, Medicare and Social Security. The good news is that I am seeing an increasing number of articles concerning these empty obligations, which, by the way, is not just a U.S. problem, but a global problem, as many other graying countries face the same choices.

*"If our democracy is to flourish, it must have criticism;  
if our government is to function, it must have dissent."*

—Henry Steele Commager, academic and author

### What's that Mountain Ahead?



*"As health care costs continue to grow faster than the economy and the baby-boom generation nears eligibility for Social Security and Medicare, the United States faces inevitable decisions about the fundamentals of its spending policies and its means of financing those policies,"* the Congressional Budget Office (yes, there is one) said in its biannual Long Term Budget Outlook. The report went on to throw out other rosy tidbits before concluding that fiscal policy could be financially sustainable *if* the growth of healthcare costs slows significantly from historical rates and tax revenues increase and/or

other spending growth is also curbed. So let's see—Healthcare costs need to slow way down (my medical insurance only went up 12% this year ☺), tax rates need to be higher, and/or Congress needs to cut back on spending. (Steve ponders another way of saying “fat chance.”)

### Is Anyone Listening?

*"I fear something like intergenerational warfare, as young people increasingly resent having their wages reduced and taxed away to support social programs for their grandparents' income and healthcare concerns."*

—Steve Miller, Chief Executive of bankrupt Delphi

This is a point brought up in Scott Burns' book, *The Coming Generational Storm*, and it will be interesting to see how younger generations react to being on the hook for their parents' bills. Economist Andrew Smithers wrote in the *Financial Times*: *Pensions call for the transfer of resources between generations. Problems follow if the burden on the working generation is too heavy or fails to secure adequate living standards for the elderly. Two conditions must therefore be met. First, the total resources available must be adequate and, second, the system for transferring resources must work well without damaging the economy through misplaced*

*incentives or increased volatility. Without massive good luck, adequate future resources require adequate savings today. In a closed economy these savings must generate growth in labour incomes through domestic investment. Wealth can then be transferred to the elderly either through the tax system or through the purchase of assets. Whichever route is chosen, the consumption of the working generation must suffer. But will they suffer unbegrudgingly?*

In addition, I read an article where Russell Mead, a senior fellow at the Council on Foreign Relations says, “*As the Baby Boomers prepare for retirement, the prospective costs to be exacted of the Social Security and Medicare program may leave Americans feeling like doing what the old urban myth says the Inuit do - ship the old folks out on the ice flows.*” As an alternative approach, he went on to recommend we “*...send the old people to Mexico, Central America and the Caribbean. ...An income that can barely cover a double-wide in Florida can swing a condo south of the border. ...The federal government should smooth the path for seniors looking to retire abroad.*” Here he was referring to expanding Medicare coverage to include foreign healthcare providers and working more closely with our southern neighbors to make it easier to travel back and forth between countries. As you can probably guess from my recently expressed thoughts on Mexico and Central America, this made me sit up and smile.

But what does our nation’s Comptroller General (head accountant), David Walker, have to say about all this? Journalist Richard Wolf wrote a cheery article for USA Today titled, *A 'fiscal hurricane' on the horizon*. In it he wrote about a breakfast conversation Mr. Walker had with the press in which he was expressing his concerns. Pithy comments such as “*We face a demographic tsunami that will never recede... Its [the U.S.] financial condition is worse than advertised and it faces deficits in its budget, its balance of payments, its savings — and its leadership.*”

Wolf’s article then went on to list other lighthearted citizens’ comments, such as:

- **Douglas Holtz-Eakin**, director of the non-partisan Congressional Budget Office, dispassionately arms 535 members of Congress with his agency's stark projections. Barring action, he admits to being "terrified" about the budget deficit in coming decades. That's when an aging population, health care inflation and advanced medical technology will create a perfect storm of spiraling costs.
- **Maya MacGuineas**, president of the bipartisan Committee for a Responsible Federal Budget, sees a future of unfunded promises, trade imbalances, too few workers and too many retirees. She envisions a stock market dive, lost assets and a lower standard of living.
- **Kent Conrad**, a Democratic senator from North Dakota, points to the nation's \$7.9 trillion debt, rising by about \$600 billion a year. That, he notes, is *before* the baby boom retires. "We're not preparing for what we all know is to come," he says. "We're all sleepwalking through this period."
- **Stuart Butler** of the conservative Heritage Foundation projects a period from now until 2050 in which tax revenue stays stable as a share of the economy but Medicare, Medicaid and Social Security spending soars. To avoid big tax increases, he says the government has to "renegotiate" the social contracts it made with its citizens.

• **Alice Rivlin** and **Isabel Sawhill** of the centrist Brookings Institution put their pessimism into a book titled *Restoring Fiscal Sanity*. Rivlin, who became the first director of the Congressional Budget Office in 1974, says it will take an "economic scare" such as the 1987 stock market crash to spur action. Sawhill likens the growing gulf between what the government spends and takes in to a "Category 6 fiscal hurricane."

So where is the big guy during all this? Well, no one seems to notice at the party, but as Alan Greenspan grabs his coat and heads for the door (he retires this month), he has been uttering warnings over his shoulder such as, "*We may have already committed more physical resources to the baby-boom generation in its retirement years than our economy has the capacity to deliver,*" and his recent comments before Congress (those members that weren't at lunch with their lobbyists), "*The one certainty is that the resolution of the nation's unprecedented demographic challenge will require hard choices that will determine the future performance of the economy.*"

Since politicians (and nearly everyone else) seem to have a difficult time understanding Sir Alan, let me translate. "Resolution of the nation's unprecedented demographic challenge"—*There are lots of people heading for the retirement exits over the next several decades.* "Will require hard choices"—*Over the past several decades, you guys sacrificed prudence over your own benefit by over promising social security and Medicare benefits and now you have to tell them the truth.* "Future performance of the economy"—*Our economy will enter a financial quagmire if no changes occur.* To put it in simpler terms (my words): *If you politicians do not get off your posteriors and begin to take this country's deficit spending seriously and figure out a nice way to tell baby boomers that they are not going to get all that they were promised, our economy will resemble the auto industry in a few years.*

*How bad how good does it need to get?*

*How many losses how much regret?*

*What chain reaction*

*What cause and effect*

*Makes you turn around*

*Makes you try to explain*

*Makes you forgive and forget*

*Makes you change*

*Makes you change*

*...If you knew that you would find a truth*

*That brings a pain that can't be soothed*

*Would you change would you change?*

*Change —Tracy Chapman*

Now, I am not trying to be a scaremonger. Many of these concerns can be alleviated if certain actions are taken, *but soon*. GM and Delphi are not alone in their pension problems, but merely indicative of further problems to come. Pensions and healthcare benefits, whether specific to the automobile industry or to cities and towns, were over-promised during a period of endless sunny skies in our nation's economic history. Now, as life expectancy continues to expand in a world of contracting assets returns, pension liabilities are growing and people are beginning to notice the dark clouds gathering. Politicians and pension managers are doing their best to try to make the numbers work. Unfortunately, the math *won't* work and the bad news will have to be passed on to retirees. The retirement and medical benefits accrued over the past several decades hang like an albatross around U.S. corporations' necks. How can they expect to compete in a world where their foreign competition doesn't have these legacy costs, pays their workers a fraction of

the U.S. wage and isn't bogged down in frivolous litigation? They can't, and they know it. IBM is the newest company to announce that they're shutting down their pension system, and they won't be the last. New accounting rules will soon require firms to move their pension costs estimates from the murky, often overlooked footnotes section of their financial statements into the meat of the report. In addition, light will be cast upon state and local government pensions as they will now have to reveal their pension shortfalls. Expect to see cities and states begin to renege on their promises over the next few years. (The recent New York transit strike was a symptom of the illness growing beneath the surface.)

As Tracy sings, we need to change. Our politicians need the courage to face the truth and our citizens the willingness to embrace the sacrifice needed.

### **On the Lighter Side**

I read this joke on several different websites during the quarter:

#### **New Element Found!**

The recent hurricanes and skyrocketing oil and gasoline prices helped to prove the existence of a new element. In early October 2005, a major research institution announced the discovery of the heaviest element yet known to science. The new element has been named "Governmentium."

Governmentium (Gv) has one neutron, 25 assistant neutrons, 88 deputy neutrons, and 198 assistant deputy neutrons, giving it an atomic mass of 312. These 312 particles are held together by forces called 'morons' which are surrounded by vast quantities of lepton-like particles called 'peons.' Since Gv has no electrons, it is inert. However, it can be detected, because it impedes every reaction with which it comes into contact. A minute amount of Gv causes one reaction to take over four days to complete, when it would normally take less than a second!

Gv has a normal half-life of 4 years; it does not decay; but instead undergoes a reorganization in which a portion of the assistant neutrons and deputy neutrons exchange places. In fact, Governmentium's mass will actually increase over time, since each reorganization will cause more morons to become neutrons, forming 'isodopes.' This characteristic of moron promotion leads most scientists to believe that Gv is formed whenever morons reach a certain quantity in concentration. This hypothetical quantity is referred to as 'Critical Morass.'

When catalyzed with money, Gv becomes "Administratium" (Am) - an element which radiates just as much energy as Gv, since it has half as many peons but twice as many morons.

### **Portfolio Happenings**

*Not a whit, we defy augury; there's a special providence in the fall of a sparrow. If it be now, 'tis not to come, if it be not to come, it will be now; if it be not now, yet it will come: the readiness is all.*

—Shakespeare's Hamlet

Given hurricanes, earthquakes, federal budget and trade deficits, the U.S. automobile industry being relegated to junk status, avian flu scares, oil hitting 70 bucks a barrel, a flattening yield curve, and Nick Lachey and Jessica Simpson filing for divorce, it's pretty amazing that the global markets held together in 2005. Sure, most investment returns were low, single digits, but besides foreign bonds, almost every area at least had positive returns. I began the year cautioning clients that we might underperform relative to the broad market averages, given our underweighting to equities. Then I decided to exit our direct investments in what turned out to be two of the best performing asset classes (emerging markets and US REITS) early in the year. Fortunately, our heavy exposure to commodities, energy stocks and gold bolstered our performance and allowed us to gain almost 9% for 2005, compared to the 7% gained by our balanced benchmark (60% MSCI World Stock/ 40% LB Aggregate Bond).

Although you may expect me to expound on how wonderful 9% is compared to our benchmarks, I will not. I am glad that we benefited during the year for investments we put in place, given trends we anticipated or risks we tried to hedge. I could just as well play Monday morning quarterback on myself and point out that we would have performed even better had I not sold out of U.S. REITs and emerging markets stocks so early. However, as I have said and proven many times before, market timing is not my forte. I like to follow investment guru Peter Bernstein's thought that investment management is more about the management of risk than returns. Besides, 2006 brings another spin of the wheel and there is no guarantee it will stop where our markers have been placed. Therefore, let us review some of our larger investment positions' "themes" chosen over the past several years.

### **Flexible Managers**

For the most part, our managers used their ability to roam far and wide wisely during the year; all but Caldwell & Orkin performed well. C&O's decision to position half the portfolio in "short positions" during an "up" year hurt their performance. However, it would not surprise me if they are the best performer in 2006.

### **Commodities**

China produces, the U.S. consumes, and the beat goes on. China is attempting to go through the same industrialization cycle that took the U.S. 100 years, but do it within only one generation. The demand placed upon commodities (steel, copper, zinc, cement, etc.) is something unparalleled in history, and it will be a miracle if China doesn't suffer some sort of setback at some point along the way. They will continue to be volatile, but Pimco Commodity and US Global Resource funds should continue to benefit in Asia's growth.

### **Energy**

What more can we say about energy? Energy stocks have been on a tear and many people on Wall Street now think their time is past and that oil will retreat back down below \$40 a barrel. Me, I have no idea where oil is going in the next 12 months, nor do I care. Energy is a long-term problem worldwide and one the U.S. is in serious denial about. It seems we panic whenever our gasoline prices approach \$3 a gallon and then go back to filling our SUVs when the prices decline. For some reason the U.S. doesn't react until there is a crisis. At the beginning of World War II, Japan took control of most of the Southeast Asia islands that the U.S. used for production of natural rubber. It almost cost the U.S. the war because the military was highly dependant upon these rubber trees for making everything from tanks to battleships. The government quickly moved to create a consortium of scientists and companies involved in rubber research to create the world's first synthetic rubber. Remarkably, they did it within two years and helped the U.S. win the war. Likewise, we are dependent on importing oil from spirited countries such as Iraq, Iran, Saudi Arabia, Venezuela and Nigeria—will it take another war for the U.S. to take this more seriously?

While I have repositioned some of our Vanguard Energy profits into an alternative energy investment (Powershare Wilderhill Clean Energy Fund), I plan to have energy be a big part of the portfolios for some time to come. By the way, it is not headline news, but in March a new oil exchange will open in Iran that will offer the sale of oil in euros. While this doesn't appear to be a big deal, I believe it will be yet another blow to the U.S. dollar, as most of the world's oil has historically been priced in U.S. dollars.

## **Gold—The Mysterious One!**

When I first introduced what John Maynard Keynes cynically called the "barbarous relic" gold, into our portfolios a few years back, I received a few odd looks from some clients and even some snickers from my friends in the investment community. I had said at the time that gold "*has historically been an insurance policy against inflation, tough economic times and currency problems,*" and although he's had some setbacks, he has proven his "mettle" of late. (Sorry, I couldn't resist.) Traditionally, "Old Yeller" has functioned as the bloodhound of the investment world, warning of inflationary pressures and currency debasements before we humans even registered a discerning whiff. Thanks to the government's manipulation of the CPI index, the markets don't seem to be concerned about any inflation problems lurking ahead. But gold has put on quite a shine these days, breaking through \$500 an ounce for the first time in decades, and investors are taking notice. Yes, most of them still scoff at him, but he is beginning to get press. One of the more respected magazines, The Economist, even ran an article in December titled *The Little Yellow God*. The article basically makes fun of "gold bugs" and tries to make a case for why gold's current price means nothing at all. I didn't take it too personally as it comes with the territory, as soon as you admit you're friends. Besides, this is the same magazine that in March of 1999, had the now infamous cover, *Drowning in Oil*, in which it tried to make the case that oil, just above \$10 a barrel at the time, would soon be headed to \$5.

Anyway, I notice I'm not getting odd looks from clients anymore and that my fellow investment-advisor friends' barbs have switched to questions about investing in gold—not that I am an expert in the "mysterious one." The market commentators may continue to downplay gold's rise and try to figure out what has "Old Yeller" so spooked. I'm not sure myself; I just feel better having him at our side going into 2006.

*"No one is listening until you make a mistake."*

—Anonymous

As stated earlier, my view going into 2006 remains the same, as does my cautiousness. As of January, the markets have gotten off to a good start, and I used it as a reason to sell another of my favorite funds over the past several years, DFA International Small Cap Value Fund. I'm sure, looking back 12 months from now, it will have had another fantastic year, but most of our clients have gained over 100% in the years we've owned it, and I feel its future holds more risk than reward, like those funds sold before it.

I have now greatly reduced (we still have some exposure through our flexible fund managers) the asset classes that helped carry us through the tough times of 2000-2003; REITS, emerging markets and international and domestic Small Cap equities. We bought them when most cared little for them, and now it seems as if everyone has their arms around them and are best of buddies. The year 2005 saw a deluge of investor money flowing into international stocks (emerging markets in particular), while just a trickle for U.S. markets. Yes, the pool's getting crowded and we seek shelter in the shallow end. I have put our assets where my mouth is and reduced our equity exposure over the past 16 months. Going forward, my caution will either look foolish or wise, but I can't let it disquiet me. I can only aspire to do my best at what I promised our clients, to preserve their wealth while not getting caught up in the moment of human emotion or the noise of Wall Street. Challenging indeed.