

“The error is clear. The herd applies optimism at the top [when the market is high] and pessimism at the bottom. Thus, to benefit, we must be skeptical of the optimism that thrives at the top, and skeptical of the pessimism that prevails at the bottom.”

Howard Marks, co-founder of Oaktree Capital

“We have two classes of forecasters: Those who don’t know and those who don’t know they don’t know.”

John Kenneth Galbraith



- **Yes, this issue of Perspectives is earlier than you have come to expect...** It struck us that the arrival of our quarterly portfolio statements – shortly after the end of each calendar quarter – might have more relevance if we provided our thoughts on the economy and the financial markets in advance. Let us know what you think.
- **As this is written...** It’s the second week in December and we, along with most everyone else, are collectively holding our breath that 2009 will come to an end without any more drama.
- **Of which we have had more than enough...** Recall that in the first three months of this year the stock market had declined an additional 25% on top of the 36% decline posted in 2008. Panic embraced the financial markets as talk of nationalizing the banking system was seen by some as the only way to save the US financial system from collapse.
- **Worse than it needed to be...** Our Spring issue noted that with the country’s leadership using a mantra of “crisis”, “catastrophe”, and “Armageddon” in their effort to motivate legislation, the hysteria-loving business media was more than happy to amplify such an assessment. The resulting fear helped accelerate the decline in the economy and the financial markets.
- **“We cannot be guided by fear”...** was our reply. But make no mistake, only our experience, along with a dose of stubbornness and collective hand-holding, kept us from letting emotion rule the day.
- **So here we are...** some nine months from the market’s low point, and the market has risen over 60% and is up some 23% on the year. Dramamine, anyone?
- **And it doesn’t get any easier...** The three most prevalent questions we hear at the moment:
“So how can the market go up with the economy so bad?”

“With all the debt the country is borrowing, won’t the dollar collapse?”

“Given the prospect for inflation, how about gold?”

- **Such questions speak volumes...** about the prevailing sentiment. Caution, indeed, *pessimism rules the day*. While we very well understand and appreciate the logic upon which this sentiment is based (**There is a lot to be concerned about.**), it is rare that such thoroughly vetted issues actually result in the worst of the perceived outcomes.
- **To invest successfully...** one must use the prevailing emotion to one’s advantage, even when you agree with the logic upon which such emotion is based...for that matter, even if you share the same emotion. The accurate assessment of such emotion and the behavior it influences is critical to assessing where the risks and the opportunities are.
- **Thus, we would be much more concerned...** were it not for this cautious sentiment. Absent another systemic crisis – which we believe unlikely – or something exogenous that simply cannot be predicted, it would be highly unusual for this to represent a significant market top (see Howard Mark’s quote, above).
- **As to the three previous questions:**
 - 1- The stock market’s rise since March has everything to do with the panic that prevailed at that time. No, the banking system did not fail. In the months since that time, the market has simply corrected for this selling. And, while it is very true the economy remains quite sick, it **is** healing.
 - 2- While we are loath to witness the scale of the borrowing by our government, ours remains the best “balance sheet” amongst the world’s super-powers. And, while there is much hand wringing about the fact that the Chinese and the Japanese own so much of our debt, they are precisely the ones who do not want the US dollar to fall. Self-interest *will* be served. If there is any doubt about the dollar remaining the world’s reserve currency, then just observe what happened when the Dubai crisis arose...Immediate flight to US Treasuries.
 - 3- While gold may be a satisfactory means of buying “insurance” against calamity or hyper-inflation, like most insurance, it is not so much an investment as a hedge. It has limited use beyond jewelry, pays no dividends, and has to be safe-kept (which comes at a cost). Witnessing the recent rise in price reminds us of the similar mania in the late 1970’s. Back then there were lots of gold dealers on prime-time TV encouraging “the benefits of gold”. Today is no exception.
- **Speaking of inflation...** with the supply of currency in the economy having been increased exponentially, there is every reason to be concerned about inflation [Ed. note: Recall our former analogy of the credit crisis to a heart attack. To get the “blood” flowing again, the Federal Reserve has injected huge amounts of “plasma” into the system]. Using a very simplistic example, if the nation’s economic activity equaled \$1 Billion dollars and the amount of currency in the system was doubled from \$1 Billion to \$2 Billion, it would suggest that you would need \$2 to buy what used to cost you \$1, i.e., the price would have doubled, i.e., inflation.
- **Expectation is key...** Important to generating such inflation is that the holders of the currency have to be spending it. Inflation *expectation* is a critical ingredient. Only if people advance their purchases in expectation of rising prices can inflation be kindled. At present, although there has been a substantial injection of currency into the system, the cash is being – almost literally – sat upon. People and businesses are being especially guarded with their cash.

- **The Federal Reserve is well aware...** of the potential acceleration of this currency as the economy heals and with it, so too could inflation accelerate. Timing the removal of this added currency will be critical.
- **Contrarian thinking...** Following the line of thought above about the prevalence of pessimism, we are perhaps more concerned about the future return from bonds than from stocks. In the process of seeking secure investments with at least some rate of return, money has flocked into the perceived safety of bonds. The result has driven their price up and their yield down.
- **Danger is lurking...** particularly, we think, in municipal bonds, where municipal finances will be extremely stressed over the next several years. Last year, many localities reduced their budget deficits only by using Federal stimulus money to narrow the revenue decline from falling property and sales tax income. Even here in Virginia – one of the nations’ strongest municipal issuers – a day hardly passes without some mention of municipal budget woes reaching crisis proportion.
- **It gets worse...** Assuming interest rates rise in the future – and the Federal Reserve has told us that such rates are “artificially low” – then bond prices will fall.
- **A short course on the bond market...** Assume you are the owner of a \$10,000 US Treasury bond due in ten years with a fixed interest rate of 3.5%. Today, this bond can be bought and sold around “par” or \$10,000. Now assume one year from now the economy has made modest improvement and the Federal Reserve begins to allow interest rates to rise. If the yield on nine year bonds rises to say, 4.5%, the market value of your 3.5% fixed-rate bond would fall to \$9,267... a decline of 7.3%. Granted, you would have pocketed the 3.5% interest and you can hold the bond until maturity, but we know from experience that to be cold comfort. The higher interest rates rise, the farther the market value will decline.
- **The perfect storm...** The combination of ever-increasing life-expectancies, the decline in the stock market, the reduction and/or discontinuance of the dividends of virtually every bank stock in the country, and now historically low interest rates have combined to create the “perfect storm” for many retirees.
- **Beware things cloaked under a veil of “yield”...** In search of income and faced with CD renewal rates of plus-or-minus 1%, we are well aware of some of the alternatives being offered to CD holders. Just repeat the mantra, *“If it sounds too good to be true, it probably is.”*
- **Planning is critical...** We recently attached a link on our web-site (www.palladiumllc.com) to an article posted by the Certified Financial Planner Board of Standards outlining basic planning strategies as part of their consumer advocacy program. Several of these really stood out to us:
 1. Spending, saving, and budgeting all play equal parts in building and protecting wealth.
 2. Investing in yourself can yield returns far greater than other investments.
 3. It’s no longer about “retirement”; it’s about reinventing yourself for the last third of your life.
 4. Do not sacrifice your own financial well-being for your children.

- **The tortoise rules!** Especially during retirement – when one is drawing from their accumulated wealth – the consistency of annual returns is critical. We updated a 2006 study by American Funds which illustrates the exponential effect negative returns pose during the distribution phase of one’s life...

		Accumulation Phase (no withdrawals)	Distribution Phase (5% withdrawal at end of each year)
Stock Market Decline	Occurrence in past 42 years	Return required to break even	Return required to break even
-5%	46	5.30%	11.10%
-10%	12	11.10%	17.60%
-15%	6	17.60%	25.00%
-20%	5	25.00%	33.30%
-25%	4	33.30%	42.90%
-30%	3	42.90%	53.80%
-35%	3	53.80%	66.70%
-40%	2	66.70%	81.80%

- **Asset allocation...** has rarely been so important. Studies have shown that over 90% of the variability of one’s return is determined by the mixture of cash, bonds, and stocks. With the return on cash near zero and bonds offering increased risk as a result of their low fixed rate, managing risk and return have rarely been more challenging.
- **Contrarian-minded...** In a world with more challenges and dangers than most of us can recall, we are struck with an unusual sense of *optimism*. Arguably simple-minded, but we would make two observations. Firstly, college enrollment is exploding (see item #2 above under “Planning is critical”). Secondly, we can rarely recall more public energy around the political process than is seen today. To which we would repeat last quarter’s nod to the wisdom of Julian Simon: *Life’s challenges often provide humanity’s greatest triumphs*.
- **Suggested reading...** With all of the questionable financial advice that’s floating around out there, we would make a couple of suggestions. Jason Zweig’s [The Little Book of Safe Money: How to Conquer Killer Markets, Con Artists, and Yourself](#) and William J. Bernstein’s [The Investors Manifesto: Preparing for Prosperity, Armageddon, and Everything in-Between](#) are both enjoyable and insightful.
- **For our many freedoms**, we are especially thankful to all who protect those freedoms.
- **To all whose eyes may fall upon this letter...** we send our sincere best wishes for health and happiness in 2010.

Year End 2009