

February 2010

## The Three P's

*But since my intent is to write something useful to whoever understands it, it has appeared to me more fitting to go directly to the effectual truth of the thing than to the imagination of it.*

~ Niccolo Machiavelli, *The Prince*

### Politics

I really like listening to smart people – it's amazing how much there is to learn. Next week I will be eating chicken and listening to economists say smart "stuff" - first with a new group called The Mid-South Association of Business Economists, that same evening with the Financial Executives International group, and later in the week with the Economics Club of Memphis. I will most likely come away from those three sessions with some new information to process as we endeavor to make decisions about our clients' portfolios and plans.

There are a number of folks whose articles I like to read; sometimes the writers or thinkers appear in television interviews and I get to hear them speak. Most recently I enjoyed a conversation between Charlie Rose (of the Charlie Rose Show) and a New York Times columnist named David Brooks (who also appears on the PBS Evening News Hour). Mr. Brooks is branded as a conservative, not in the vein of many of our politicians, but rather as a thinker with carefully crafted opinions and thoughts. The things I really like about him are his demeanor and recognition that he's not the only one with intelligent ideas.

I personally am not so much into politics. For one thing, it's not such a good idea since I seek to please all the people all the time, and secondly, because I'm generally offended by the way most politicians seem to act and express their views. However, the conversation with Mr. Brooks got me thinking about something and I've decided to lay out some thoughts and hope all will take this with the fair spirit it is intended.

We may be inadvertently causing our politicians to make decisions that it's likely few of us (including the politicians) really support. Our government is spending at huge deficit levels, yet we seem to be reluctant to accept fewer government-provided benefits – ranging from healthcare (including Medicare), to other services, to security, to entitlements like social security, to infrastructure, etc. At the same time, it's unlikely that many of us really relish the idea of higher taxes.

So perhaps we are encouraging our elected and appointed officials to maintain or increase services and benefits (spending) while discouraging revenue increases (taxes). There is certainly some middle ground here; encouragements to businesses and entrepreneurial efforts may result in higher tax revenues without increasing rates. And, there is a sense that government spending on infrastructure and economic stimulus may save a few bucks by helping some folks become less government-dependent. But, it seems illogical that increased spending and static revenue turn out for the best. The result is increasing deficits which, taken at the household level, we call debt. It's just unlikely that we can spend our way out of our current fiscal woes.

I am really not trying to take a stand in favor of more or less government spending, and I'm certainly

not wishing for the opportunity to pay higher taxes. What I'm suggesting is that the future generations (our kids, for example) are likely to be burdened by our reluctance to make the sacrifices necessary to exhibit fiscal responsibility. It's a pretty simple thing – no matter how much we make, we should simply spend less than comes in. Let's encourage our government institutions to do the same.

## **Portfolios**

You will recall that last fall we moved the throttle back on our equity (stock) allocations a little (about 5%) because the stock market valuations had moved modestly above our calculated fair value. From that time through the end of the year, the equity markets increased to somewhat higher levels without significant changes in the underlying fundamentals that drive their intrinsic value. So, in early January we moved the throttle back another notch.

With the fall movement we reduced the traditional equity exposures and replaced them with increased holdings in the absolute return category (like equities but with decreased expected volatility). With the January movement we desired to replace the traditional equities with utilities because of less historical (and logical) volatility and because of the nice dividend yield associated with the utility sector. For the most part we were able to make this move, but in some clients' portfolios we feel constrained by the tax consequences of significant built in gains (short-term) due to the precipitous rise in the equity markets in the last three quarters of 2009. We should be able to complete this adjustment in the next couple of months as many of the holdings move from short-term to long-term and become eligible for more favorable tax consequences.

On the liquidity or bond side of our portfolios we continue to be concerned about the effect on bond values due to rising interest rates. Higher rates are not certain; the timing is not predictable. However, indications are certainly in favor of higher rates in the not too distant future. The shorter the time to maturity of bonds or bond funds, the less volatile they should be if rates change. There is an inverse relationship between bond values and market interest rates, so if rates go up, the value of bonds will go down. We told you last month that we are battenning down the hatches, and in January we made significant adjustments in the direction of shorter average maturities in our bond fund holdings.

From the perspective of personalization or specific client allocation, we have fine-tuned our methodologies. Essentially, the paradigms we have in place take into account our clients' age(s), anticipated cash needs over the next several years, their history of cash needs or additions, and our understanding of their attitudes toward volatility in their portfolios. We invite all to come see us for consideration and discussion of these and other topics.

## **Prospects**

### **Liquidity (Bonds / Fixed Income)**

In the preceding section I mentioned our concern about rising interest rates and our movements to shorten the average maturity in our portfolios. The good of this is that it removes much of the risk associated with falling values if interest rates rise. The bad is that the yields (interest rates) on the short maturity funds are very small. Last year was a particularly good year in the bond world; the preceding year was good for government bonds, bad for municipals and corporates. By keeping maturities short we should be able to avoid disasters, but are unlikely to have significant returns on the bond or liquidity side of our portfolios unless/until interest rates rise and better yields are available.

### **Prospect-based (Equities / Absolute Return)**

As I also mentioned above, the equity markets remain a little higher than our calculated fair value. This is a subject where we have to be cautious – just because we are able to calculate “fair value” for the markets does not mean that buyers and sellers will all rush to push stock prices to their appropriate, calculated values. History gives us a tale of perpetual over-and under-valuation for equity prices. What we do know is that the risk rises as prices rise above fair value and opportunities increase when prices are near or below fair value. Our tactical methodology is to reduce general or total equity exposures if/when prices are above our calculated means and take a neutral or equilibrium stance when prices are at or below fair value.

Let’s examine a little history to try for some perspective as we look forward. When the previous decade began (2000), equity prices were further above fair value than at any time in the entire 20<sup>th</sup> century. The fact that equity (stocks) performance for the last ten years was significantly lower than historical averages can be explained very simply by the starting point – stocks are simply not going to stay above their fair value for extended periods of time and the last decade is a poignant example.

We begin this decade with stocks at or a little above their calculated fair value. That suggests that returns looking forward are unlikely to be above historical averages. The prospect of rising interest rates, other anticipated money tightening initiatives by central banks, modest growth in business activity, and some understandable caution from investors all coincide to reinforce this theme.

*...do as prudent archers do when the place they plan to hit appears too distant, and knowing how far the strength [virtue] of their bow carries, they set their aim much higher than the place intended, not to reach such height with their arrow, but to be able with the aid of so high an aim to achieve their design.*

~ Niccolo Machiavelli, *The Prince*

So, we want all to recognize the constraints on expected and available returns as we move through the next few years. Modesty and caution should be our themes. We think that there can and will be some value added through tactical moves. We think that diversification and cash flow planning will be helpful and fruitful, but we do not anticipate precipitous and prolonged increases in equity valuations. On the other side of the coin, there is no particular reason to show great concern – asset prices are reasonably valued and we expect higher interest rates to provide some yield-based returns in the coming years.

Call or come see us anytime you’d like to chat.

May God Bless you and yours,

***Doug***

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