July 2008

Let's Take Control

The best years of your life are the ones in which you decide your problems are your own. You do not blame them on your mother, the ecology, or the president. You realize that you control your own destiny. ~ Albert Ellis

You cannot prevent the birds of sorrow from flying over your head, but you can prevent them from building nests in your hair. ~ Chinese Proverb

At any time you can decide to alter the course of your life. No one can ever take that away from you. You can do what you want to do and be who you want to be. Nature is constantly at work around you. Character and destiny are her handiwork. She gives you love and hate, jealousy and reverence. You have the power to choose which impulse you follow. While your character is formed by your circumstances, your desires can shape those circumstances. The one thing over which you have absolute control is your own thoughts. It is this that puts you in a position to control your own destiny. Your greatest power is the power to choose. ~ Unknown

Being out of control is one of the worst feelings in the world, sometimes even worse than pain. It is its own kind of pain. ~ Danzae Pace

Dear Friends,

I've told you on a number of occasions that good, disciplined investing comes from the head. There are mathematics and logic and historical precedent - insight and intuition - good old American ingenuity, and a certain wisdom developed from study and experience. The problem is that sometimes "doo-doo occurs" and the simple fact that our stomachs have some physiological and emotional attachments to our thinking cause us to become confused. The month of June - and to some extent - the period beginning last summer, will be a good test of whether we control our investing temperament through our emotions or through our acquired wisdom.

The things I really want to visit with you about are the simple questions of who's in control, and upon what can we, and should we exert our influences and control?

The essence of the portfolios that we build and manage on behalf of all our clients is a prudent and proven recognition that we should control the things we can and accept that there are a number of influences over which we have no control. We speak of the former as the controllable elements of portfolio management and present them to you as often as possible:

- Diversification
- Recognition and funding of cash-flow needs
- Recognition and minimization of cost elements of the portfolio
- Tax– efficiency

It is with a steady focus on these elements that we build the models that underlie our clients' portfolios, and it is upon these elements that we reduce or mitigate the influence of the factors that we do not control – most recently and pungently, the greed and resultant poor decisions made in the U.S. mortgage world, the frightening rise in oil and gas prices, the value of the U.S. dollar in international currency markets, and the out of control spending in our consumer, corporate, and government sectors.

Let's think for a minute about where we are in the economic world: Are we in or approaching a recession? Is this the worst financial crisis since the Great Depression? Well, we are certainly experiencing a crisis in the housing market – about one million homes are in foreclosure and that number may swell to 4 million. The dollar is low as compared to most other currencies. The real underlying question is whether this is a normal downturn or something more fundamental. I submit that the fairly slow rate of economic activity is likely fairly short. The Federal Reserve has done some things to stimulate activity, tax cuts remain in place and some have been extended, and the federal stimulus checks are beginning to feed into purchasing. So, there are some activities in effect that should soon help to stimulate the general economy.

The question of fundamentals may be a little more vexing. We are experiencing declining productivity growth and the continuing decline in the relative value of the dollar. Both these items affect purchasing power – which is declining. It may be that we are in the midst of a payback for all the spending we have been doing. Our habits (consumer, corporate, government) have included borrowing (big) for houses and consumer purchases, importing goods instead of producing them in the U.S., corporate stock buy backs, and government spending at a deficit level.

It may very well be that we have created a mirage, a standard of living that we cannot really afford. We are experiencing price inflation in oil and energy, food, healthcare and education (to list a few important areas). Price increases will only serve to exaggerate the problems if we are spending above our means.

The U.S. has "sucked up" the savings of the rest of the world and consumed it. China, Japan and the oil producing countries are enormously large holders of our debt (U.S. Treasury Bonds). They send the money, we send the "IOU", we spend the money on things they make or produce and the circle continues. China and many other emerging economies are investing while we are spending. Oil producing countries have been saving much of that oil as oil reserves instead of "converting" it to dollars.

Our enormous consumer spending habits have been growing at unprecedented rates. Spending eliminates investing and capital availability is lacking. Many corporations have instigated stock buyback programs instead of investing in their own infrastructure – technology, productivity, research, etc. The government has been spending instead of investing in infrastructure to facilitate economic growth.

Is all this irreversible, and are we seeing the demise of capitalism and the American way of life? I think not, but I absolutely believe we need to make some significant and immediate strides to offset the lingering effects of our spending habits.

Let's save more and spend less – remember the control issue above – we can control our spending. Let's encourage our governments to invest in infrastructure instead of continuing to spend on shorter-term activities and programs. Let's tell our businesses to invest – in technology, productivity enhancements, and research. In short – let's begin to change our behaviors. We are not in an easy situation – it's not a headache where we just need to lie down for a while. We need significant lifestyle and attitude adjustments to regain control of our economic lives.

So what about my real job, which is about managing our clients' portfolios? Well, we plan to even further enhance and extend the diversification inside our portfolios - particularly in the area of non-traditional asset classes like energy, raw materials, metals, etc. We are closely watching the bond markets for opportunities as price inflation affects interest rates. We will be more closely monitoring and reminding our clients if their withdrawal rates exceed the 5% annual threshold.

In the traditional equity areas, it is obvious that stretching out the non-traditional asset classes will affect the allocation to good old equities. The general equity markets are down from their October 2007 peak by somewhere around 20%. I don't have a crystal ball or ever expect to make short-term market predictions. However, if we presume that capitalism will prevail and the American way of life will survive, then stocks are starting to look pretty cheap and we may soon start to see the bargain hunters buying at these depressed prices. Don't get all excited – I didn't just predict a near-term market rebound, I merely think that values are starting to accumulate and all the money on the "sidelines" may be poised to appreciate what should over the long term be rather profitable valuations.

In short, it's like an old buddy of mine in the restaurant business used to say – we'll be working like hell – recognizing and reacting to the things we cannot control and putting ever-greater emphasis on the things we can.

I know things are scary- call or come see us when you can.

May God bless you and yours,

Doug

douglas smith, cpa/pfs
managing director, chief investment officer