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2010 Third Quarter Investment Commentary

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"Those who want to reap the benefits of this great nation must bear the fatigue of supporting it."
-Thomas Paine

"Much of American wealth is an illusion which is being secretly gnawed away and much of it will be completely wiped out in the near future….So what is the rest of your future? A grisly list of unpleasant events-exploding inflation, price controls, erosion of your savings (eventually to nothing), a collapse of private as well as government pension programs, and eventually an international monetary holocaust which will sweep all paper currencies down the drain and turn the world upside down."
-Howard Ruff

"The single most important thing we want to achieve is for President Obama to be a one-term president."
-Mitch McConnell

Through September 30, 2010
Our average return for all accounts +14.2%
The DJIA rose only 3.85%
The S&P 500 by only 2.7%

Early in this year, I suggested that we would not have a double dip downturn in our economy and that the year would unfold with positive rather than negative surprises for our investments. September delivered the best upward run in stock prices in 71 years. We continue to have good fortune in weaving through the "doom and gloom" that feeds the "Wall of Worry" that propels stock prices higher. Two years ago, we faced the abyss. Today we can breathe. The restructured General Motors IPO starts trading today (November 18, 2010).

I will work to keep this commentary shorter than my last one. However, no promises, as once I begin, I am off to the races.

The first quote above by the author of Common Sense, speaks well of our patriotic duty to carry the cost of running our nation. We have two wars we must pay for. These may well cost us over $3 TRILLION dollars. We should not pass this burden onto our children. To pretend that we should not increase taxes for those most able to pay for this is absolute foolishness and selfishness. A country can only sustain itself and prosper when those who are able are willing to sacrifice for the good of the nation. If we do not, we will fold, as have all the other mighty nations that came before us. We have Americans dying in Iraq and Afghanistan and at the same time have Americans here with income of over $1 million annually, and they don't want their taxes raised a smidgen to pay for the war? Please!

The second quote above paints a grim picture. Could this be the eventual result of our governments' stimulus that some believe kept us out of depression? What should we do: run for the hills; join the Tea Partiers; sell everything and buy gold; buy a survival kit with a years' supply of water and grains; store up duct tape; build a fence around our borders? Or, is Mr. Ruff just another narrow-minded fear monger spreading his pain?

The third quote is from our current Senate Minority leader. It does not speak well for moving our country forward. Such an attitude only contributes to failure, not progress, for our country. Why aren't jobs, moving our country into the 21st Century, placing our economy on firm footing or ending these wars priorities for today's Republicans? Why in the world do Americans keep electing such people to represent us?

If you have not read my last commentary, please do. There, I attempted to lay some underpinnings for a sustainable American economy. Since only two recipients of that commentary called to inform me that page seven was missing, I know that most of you did not quite make it through to the end. I could be as wrong or as right as the next person could in prescribing possible remedies, but at least I have tried to draw from my understanding of history, economics and tax code to arrive at my thoughts. I suppose that we all have done the same to some extent, but too much of the stuff circulating in our media seems grounded in fantasy or nonsense. For example, our politicians continue to harp on our budget deficit, but none of them reflects any understanding between debt incurred for capital improvement, i.e. infrastructure, and that incurred for current expense. Others cry about not wishing to pass on the enormous debt onto our children and grandchildren, but few are willing to sacrifice today, by raising taxes and targeting these to pay it down. While Congress fiddles, only our Federal Reserve has the freedom to work against a deeper economic downturn with monetary policy adjustments. Therefore, The Fed must implement QE2 in the face its critics and the consternation of our trading partners to flood the markets with dollars. If Congress would seriously address the deficit matter with targeted tax increases, this would not be necessary. Instead, certain members stone wall for political gain. Taxes raised specifically to pay off the deficit would more than be returned to those who pay them by the increase in the value of investments in a strong and sustainable economy. Some moan about impediments to small business, the greatest of which is the significant rise in health insurance over the past thirty years, but they refuse to offer any substantive remedy other than privatization and free-markets. Do you know that Congress still excludes our medical insurance industry from anti-trust laws? If you are a true believer in free markets, then first on your agenda must be the breakup of this lock on profits by removing this exclusion. Yet, those who oppose the recent health care legislation never raise this.

The insurance industry has such a strong hold on our citizens and some members of Congress that change in the game is almost impossible. We must break this lock to be free of the unending increase in medical premiums. When will it happen?

In 1984, I could purchase a $10,000 deductible major medical policy for about $450 annually. I was young and healthy and thought that I would invest the savings between this high deductible major medical insurance and the regular policy. Then individual coverage cost about $158 monthly. Within six years, I would have banked my deductible, holding a medical account valued at $11,456. By age sixty-five (thirty-three years) at 8% annually; I would have accumulated over $227,925. Had Congress passed legislation that allowed me to deduct my contributions, this strategy would have delivered results that are more impressive. Today individual coverage with a $2,500 deductible costs over $500 monthly. $10,000 deductible plans are no longer available.

Yes, the insurance industry removed this product from the market. Why? I suspect that if we all did what I attempted to do, the insurance industry would have lost control over the huge annual cash flow that it has come to covet. Shortly thereafter, Congress passed legislation that gave us medical savings accounts with a high deductible insurance policy. The insurance industry went along the idea by issuing "High Deductible" contracts of only $2,500, not $10,000. However, the industry priced these at only a few dollars less than the non-deductible plans. Therefore, the economics of buying a high deductible plan made little sense. Why? Again, I suggest that so the industry could keep the huge cash flow of premiums.

We have an industry that is not subject to anti-trust laws. We cannot purchase coverage across state lines. We have little uniformity in coverage throughout the fifty states. We have premium rates increasing at rates of over eight percent for the past thirty years now, consuming close to 30% of our Gross National Product. Still, we have people calling for solutions that do not involve our government. Access to medical care is a utility as important to Americans as is electricity, transportation, clean air and water. This necessity cannot be so expensive that families must drop coverage in order to pay for food or mortgage. The private sector has failed to address the problem. I am sorry, but the CEO of United Health is not entitled to a $122 million annual payday, while fellow citizens are losing their homes due to medical bankruptcy or their lives due to inadequate coverage. We are Government and we need to address this matter now. The legislation passed last year, with great political sacrifice by many, is a step towards this. Our current President and this Democratic Congress (sorry to my Republican friends, but your people did not help this time), unlike so many of their predecessors, did not kick this problem down the road.

The diversity of thought and opinion in America does not trouble me. Diversity is one of the characteristics that make us great. It is the firm reluctance to listen to each other, to strive for understanding and wisdom, to reach compromise or respectful disagreement. The public discourse in America today, especially those of our media pundants and politicians, is most troubling. As Jon Stewart, so poignantly stated at his recently rally in Washington DC, these people work to extremes to pull Americans apart. We are all not that different from each other. Nevertheless, the firmness of position rooted in philosophy, belief and out right ignorance, instead of practical experience or fact is outright scary. It was Daniel Patrick Moynihan who stated, while he served in the Senate that, “everyone is entitled to his own opinions-but not to his own facts.” It is ironical that we have more information readily available today than ever before in history via the internet, yet seem to have a difficult time sorting fact from revisionist history.

Two years ago, our economy teetered on the abyss. Our financial industry, our auto industry our housing industry and our overall economy were on their backs. Today due in great part to decisions made by some of our elected officials, we are in economic recovery. We are in a better place than anyone thought possible twenty-four months ago. General Motors is out of bankruptcy. Its IPO begins trading today. Our economy has expanded for five consecutive quarters. Our Treasury is recovering the money with a profit that it lent via TARP (Troubled asset Relief Program). Income taxes are lower due to the passage of the stimulus package. Corporate profits have rebounded almost to pre-recession peaks reached in 2006. The Standard & Poor’s 500 stock index is up more than 47% since January 2009 when President Obama took office. Our banks are sitting on over $1 trillion more in reserves than they require. Our publically traded non-financial companies hold more than $1.85 TRILLION in cash and other liquid assets. This is 14.7% of U.S. market capitalization. Congressional Budget Office projects Healthcare Reform to bring down our deficit. YES, we still have a long way to go for full recovery and lower jobless rates, but we are moving forward. Can we give credit where it is due and stop tearing down those who worked so hard to keep us from the abyss?

Today, in addition to health insurance reform, we have financial reform and finally a Bureau of Consumer Financial Protection. Sorry, for those who think this unnecessary, one who has been in this business since 1977 believes that America needs this protection. We must restore confidence in our financial system for the individual American. Legislation now on the books may not be the best. However, prior to 2009, Congress did nothing to address two major issues that are so critical to sound economic footing in our country. The unregulated, unfettered, free-markets, government-is-bad crowd bamboozled every attempt to reign in excesses. Meanwhile disparity of wealth in America grew wider and a majority of Americans grew poorer. However, do not blindly believe me. Look around your neighborhoods. Look at your own situation and that of your neighbors. Are you better off financially today then you were ten years ago? Today 14.7% of American households are “food insecure” according to the Department of Agriculture. This is the highest level in 15 years! One in seven households suffers from inadequate food.

Smart regulation, not dumb, weak regulation, is essential for our long-term economic health. Alan Greenspan, a proponent of Ayn Rand and her free-market philosophy, and most influential as Chairman of the Federal Reserve over the past twenty-years, came to admit his error in judgment upon reflecting on the havoc wrought by our recent financial meltdown. Ironically, on November 12, 2010, someone is suing the SEC for failure to regulate Bernard Madoff. Can you imagine? Our government, since the 1980's, continuously weakened regulation. America got less regulation and unfettered free markets. Americans lost billions in the financial meltdown and the greatest Ponzi scheme in our history and now, on top of this, we must pay to defend the weak regulation that politicians wrought. Can't they sue the politicians who refused to strengthen our regulation and then who took jobs in the financial sector instead of the underfunded SEC? No wonder higher beings have called planet Earth the insane asylum of the universe. It is! Humans are nuts!

Oh, yes, I wanted to keep this brief. To this point, I am enclosing two progress reports for your review this quarter. The first is your year-to-date performance through September 30. The second is performance over the past two years, going back to September 30, 2008. Recall that Lehman Brothers collapsed in September 2008 and the crisis commenced. As fear took hold of our collective consciousness, I quoted Jason Zweig, Robert Doll, John Templeton, Warren Buffett and others stating that we will look back a few years from now and wish that we had bought more stocks. I recommended holding positions, buying and waiting through the crisis. We, who held on and did not panic out of our investments, have been rewarded.

For the two-year period ending September 30, 2010
Our average Return of all accounts was +16.9%.
The DJIA - .5%
The S&P 500 + 3.16%.

Remember that our average return reflects the composite of all clients and their individual investment preferences. This number also reflects those who sold in a most inopportune time and in doing so brought down our overall average returns. Our individual progress reports post your actual returns. Use these averages as benchmarks for comparative purposes.

We have found that most of our mutual fund investments over these past two years have performed miserably compared to our individual stock selections. In the past, we have favored mutual funds as a foundation for smaller portfolios, i.e. those under $30,000. The funds provided diversity that we could not obtain with individual stocks for smaller accounts. CGM Focus, up until 2008, was a stellar performer with average annual returns exceeding 16%. Since 2008, however, its poor performance has dragged down our averages. I suggest that in down or flat markets, the funds are not nimble enough to move advantageously through the markets and that their fees eat away at gains when the growth is not significant. At any rate, we have recently decided to lighten up on our CGM Focus holdings and other mutual funds that have lagged our overall performance results. IF your performance this year is under our averages, you may find the culprit to be CGM Focus. This fund is down 35% from September 30, 2008, a significant contrast to our +16.9%. We held out hope that Mr. Heebner, the fund manager, could turn this around. While he may eventually do us, we have lost patience.

Howard Ruff, quoted at the beginning of this essay, was a perpetual doom and gloomer who sold books, gold, silver and survival kits in the 1970's and 1980's. While his statement could very well have been made today by some, he made this statement in 1979. His Ruff Times scared the woolies out of many Americans. Fortunately, his forecast proved wrong. The great equity boom that commenced in 1981 eventually silenced him. However, many today take up his mindset: fear still sells. In 1979, the DJIA stood at 838. Our Gross Domestic Product was $2.5 Trillion. Today, 31 years later, the DJIA trades at 11,176 and our GDP is $14.8 Trillion. 2041 will mark 31 years into our future. If our economy expands by only half of what it did over the past 31 years, we will have a GDP of $43 Trillion and a DJIA of 74,488.

I do not mean to dismiss the economic clouds hovering over us. We will always have them. However, and this point is not new to you who have been with me for many years, I believe we will overcome the trouble before us and prosper. Trouble and crisis brings opportunity. We continue to build our portfolios with holdings that should prosper as the years go by. Market weakness presents opportunity to and to positions.

Please, as always, give me a call to discuss your portfolio and your individual financial needs as they arise. Thank you again for your continued business and confidence.

Our Retirement Cash Flow Analysis is a great tool to chart your future cash flow planning. Whether you have children going to college or planning how you may afford retirement, you will find this service most helpful in illustrating how you may fare over the next twenty-five years. I recommend that you call and make an appointment either to undertake your first RCFA or to update your last one. Our work with you in preparing this also gives us the opportunity to revisit your overall financial planning and answer any questions your might have concerning your finances. Call us to work on your 2010 Cash Flow Analysis.

Until then, or our next note, enjoy the Holidays!

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