

# MARKETPOINT



## THE WORLD AS WE KNOW IT

**THERE IS AN OLD SAYING** that if you spent 15 minutes thinking about the economy, you wasted 13 minutes. While this is true when it comes to forecasting the future, there are some features of the US economy that are relevant for how investors position their portfolios. The implications of continued outsourcing to developing markets and foreign lending to US consumers leads us to believe that there is systemic risk to dollar-denominated investments **and** that portfolios set to track

the S&P are likely to disappoint over the long term. While the S&P had a pretty good year in 2006, it is our view that many attractive opportunities can be found elsewhere.

It is well known that US citizens are fairly profligate compared to many of the other world citizens. Yet, US' workers are the most productive, its laws protecting private property are the most secure, it has the best universities, and currently, it offers the highest returns on risk-free capital with short term rates set at 5.25%. Therefore, investment continues to flow into the US from abroad.

But there is a problem. The 61-month-old expansion fueled by credit creation (much of which originates abroad) is getting long-in-the-tooth, and total debt-to-GDP is the highest on record, putting us at risk of a future that differs significantly from the recent past.

The chart on the following page shows that the US economy is highly levered at present. This means that more and more of the value of our production goes to servicing debt, as opposed to being reinvested in productive assets located on our own soil. This is critical because our wealth (net worth) is being transferred abroad to the extent that the proportion of lending originates from foreign sources, a proportion that has increased dramatically. It is tough to pin down the exact figures because much of the lending happens in the opaque derivatives markets, but, as an example, foreign claims on US financial assets has gone from 24% in 1999 to 34% in 2004<sup>1</sup>, a large percentage increase over 5 years.

The investment implications of both the growth in total debt and source of credit are numerous. Since it is mathematically impossible for credit to grow faster than GDP in the long run, Stein's Law says it will stop (Stein's Law: "If something cannot continue forever, it will stop."). When credit expansion (in the US) **does** stop, and we're not making a prediction **when** that will occur, it is likely to affect asset

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<sup>1</sup> Source: *Statistical Yearbook of the United States*, 2006



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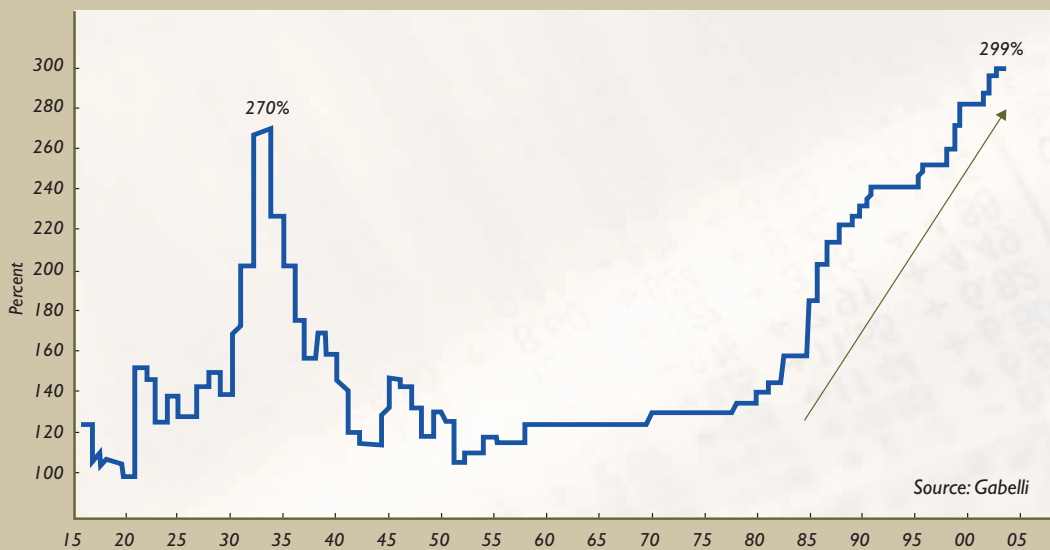
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prices and the dollar, which in turn will likely show up as slower standard of living increases in the US vis-à-vis other countries. This is an important element of our investment strategy.

While the US probably has the highest standard of living in the world, the living standards in countries that have been utilized as a source of cheaper labor are rapidly increasing. This means high continuing demand for commodities (even if the US economy slows), because **commodity consumption is directly tied to standard of living**.

To illustrate how far this can go, per capita oil consumption in the US is 14 times higher than that in China and 32 times that in India<sup>2</sup>, two countries that have a combined total of 2.3 billion people. Suffice it to say that energy demand is likely to go a lot higher and with major oil fields in production decline, resources in politically secure areas are increasing in value despite how the market prices them day-to-day.

Total Credit Market Debt (all sectors) as % of US GDP



The energy weighting in the S&P is now 9%, up from 6% at its bottom in 2000, but still down significantly from its high of 27% in 1980<sup>3</sup>.

The metals weighting is insignificant. This shows that investors in US stocks are still skeptical of the idea that companies engaged in the exploration, production and distribution of much needed materials aren't worth very much relative to other investments. We differ from this view and intend to invest our clients accordingly.

While we can't predict how markets will shake out in the near term, positioning your portfolio for a goldilocks economy (low interest rates and commodity prices with strong growth) may end up being very costly. It is our job to manage certain risks, so our strategy remains to invest in the context of global developments (not **current** consensus viewpoints) and thereby to own certain investments currently disdained by the establishment. At times this strategy will be called into question, but it is better to make money uncomfortably than to lose money comfortably ■



<sup>2</sup> Source: CIA World Factbook, 2005

<sup>3</sup> Source: Ned Davis Research

# TOP OF MIND

## IMPROVING YOUR INVESTING TEMPERAMENT

**AS WE'VE SAID IN THE PAST**, temperament is more important than smarts in investing. It is easy, even for professional investors, to fall prey to the psychological pitfalls that turn us into our own worst enemy. Recognizing these fallacies is the first step to improving your investment discipline. Here are some suggestions:

**1.** Think like an owner. Pay attention to how the businesses of your portfolio companies are doing and not how "Mr. Market" is pricing your stocks on daily basis.

**2.** For stocks, take a 5- or 10-year perspective and focus on long-term outcomes, not what happened in a particular week, month, quarter...or even year. This is exceedingly difficult for most people because there is an overwhelming tendency to extrapolate recent price movements far into the future. Past price movements **DO NOT** predict future prices at all. **Please repeat this sentence until you believe it in your soul.**

**3.** Expect volatility. It is normal for the stock price of a given company to vary by 35% between the high and low in a year. Yet, at the

same time, stocks of good companies that are attractively priced tend to increase over time. So while it is difficult to guarantee a positive return over a year or two, odds dramatically favor the long-term holder with time.

**4.** Know that a consumer experience with a product does not make the stock of the product's company a good or bad investment. If you made such an extrapolation 5 years ago, you would have avoided Sears as an investment (because of empty stores and poor service) and loaded up on Wal-Mart. The reality is that Sears had lots of room for improvement and a very cheap stock and Wal-Mart had many areas in which to stumble and a very expensive stock. Guess which one had a better return.

**5.** Pay scant attention to your basis. The only relevance it has is to calculate a tax liability or benefit, and even then, be very reluctant to let the tax-tail wag the dog. To change investments merely for tax reasons can hurt your after-tax return because it potentially has a very high opportunity cost. Remember, the market has no memory of where you bought a stock.

**6.** Forget about what the market is doing and/or guessing what it will do in the short term. Those thoughts corrupt the focus on what it takes to own attractive long-term investments.

**7.** Know that what other people say about an investment doesn't matter. The only thing that matters is the correctness of **your own** analysis. And with that, know that you will be wrong more often than you expect. As the great Peter Bernstein (former money manager) said, "The future is not ours to know. But it helps to know that being wrong is

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inevitable and normal, not some terrible tragedy, not some awful failing in reasoning, not even bad luck in most instances.” A thorough investment process is the best way to have a respectable batting average, but even the best investors have many outcomes they didn't anticipate.

Apart from correctly analyzing investments in a prudent manner, controlling natural human tendencies can significantly improve the odds of success. While there are many other emotional elements not outlined here that can lead to counterproductive actions, just being aware of those mentioned above will surely help improve returns. ■

# OBERMEYER PERSPECTIVE



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**ABOUT 4% OF AMERICANS ARE VICTIMS OF IDENTITY THEFT** each year, and the cost and hassle of such an event warrants taking some precautions. The following recommendations may help identify areas where you are vulnerable:

- Treat your personal information and passwords as if there are cash ready to be stolen. Use a shredder and don't leave this information in the trash or your wallet. Don't give this information out to any unsolicited callers.
- Safeguard computer information. Use a firewall along with virus and spyware protection. Don't log on to any sites containing your personal information from public computers—they may contain spyware. If you have a wireless network, make sure to enable the security features.
- Don't respond to emails with "fake" links designed to get you to submit your financial information under the guise of "updating" your account.
- Set your Blackberry, PDAs, computers, etc. to timeout and require a password to log back in. This will help protect you if you lose a device.
- Most identity theft occurs at home. Cleaning people, errant teenagers, workmen—many people have access to personal information. Be discreet and lock this information up.
- Each credit-reporting agency offers one free credit report a year. It is a good idea to periodically check the report to make sure that someone isn't obtaining credit under your good name.

Ongoing precaution and common sense are the best defense. You can rest assured that our firm takes considerable strides to protect the security of our clients' personal and financial information. ■

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Past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be suitable for an existing or prospective client's investment portfolio. Therefore, no existing or prospective client should assume that future performance of any specific investment or investment strategy (including the investments or investment strategies recommended herein) will be profitable or equal any historical performance levels.

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