

## **June 2010: A Choppy Start to the Summer**

*(Updated 06/08/10)*

Last month was a struggle for almost all asset classes as the general market environment continued to shift from tempered optimism to complete pessimism. Many investors have moved for the exits, withdrawing support for long-term investments and parking in cash and Treasury bonds to await a return of clarity and confidence.

What is causing so much market volatility and fear? In our book, it's 4 big factors:

1. The rise of China and India and rebalancing of global political alliances
2. The impairment of Wall Street after it got carried away in disgorging Main Street America of its wealth
3. Extreme government intervention in all levels of the U.S. economy and the associated uncertainty of how private capital can/should be allocated
4. The potential consequences of the eurozone debt crisis

These days it is admittedly difficult to be confident in the future on many levels. With dramatic selling in stock markets and other riskier investments over the last 6 weeks, and after having experienced firsthand what a 50% down market felt like in 2008, investors are understandably jittery. To compound investor angst, the rhetoric from Washington makes it clear that its policy will be to extract funds from the investor class – the entrepreneurs, innovators and businesspeople (both current and former) – to pay for its growing list of liabilities and entitlement programs (e.g, social security, healthcare, PBGC, FDIC, etc.).

Over the past two years, the U.S. government has engaged in numerous fiscal and monetary manipulations, whose purpose was to forestall or reverse the deflationary impact of a collapse in the real estate values and a severely weakened banking system. These policies include slashing interest rates to zero, quantitative easing, guaranteeing deposits, guaranteeing money market funds, lending to banks and allowing the Federal Reserve to lend against inferior collateral, providing capital infusions into banks and insurance companies, lending to foreign banks which operate within the U.S., and many other mechanisms to help return the banking industry to a near normal operating condition. These measures were beginning to work to restore confidence, but then a series of headlines (BP, Goldman Sachs, Europe, etc.) hit the newswire.

A banking crisis in Europe is increasingly possible and some European banks may have to be nationalized. It's hard to predict the probability of a cascading debt crisis in the PIIGS (Portugal, Italy, Ireland, Greece, and Spain) countries and what damage it could do to the rest of the global economy... it could indeed stress global equity prices for a period.

Is everything doom and gloom? We think not.

We remain of the view that it will be difficult for the global economy and especially the U.S. to double-dip back into recession with interest rates at zero (and the yield curve as steep as it is), with lower commodity prices and with much improved corporate profitability. Moreover, should asset prices decline further, rest assured there will be further fiscal and monetary stimulus and, if/when it comes, it will be *more targeted and effective* and not in the form of handouts to key political constituencies.

Also, the whole eurozone region has not contributed much to the global economy for the last 5 years, so absent an outright recession, stagnant growth in Europe may not mean much for the rest of us.

There are also areas of the world that are growing nicely and that aren't saddled with large amounts of debt. China grew at 11.9% in the first quarter of this year, and India grew at 8.5%. Yes, this pace of growth probably won't continue, but it illustrates that some economies can progress amidst turmoil in the OECD.

During risk-averse environments like this, long-term investors have historically been rewarded for taking advantage of the short-sightedness of others by stepping up to buy claims on high quality investments on the cheap. While doing so requires some courage on the part of the investor, ignoring the noise emanating from CNBC and the sensationalism of the financial press can be highly profitable.

It is not our game to try to guess short-term market movements. We are not aware of any speculators who can do this with any long-term consistency. We instead choose to hold interests in good assets that we believe will be of greater value over time and to employ a sensible investment strategy given the global risks of which we are aware.

We recognize that financial markets are in a rough patch and the global economy will probably experience sub-potential growth for a while. Indeed, the pace of economic expansion will likely slow for the foreseeable future, which is what the stock market has been pricing in of late. But softening growth is normal after a period of rapid expansion like we had off the bottom at the beginning of 2009.

The bottom line is that *for long-term investors* it doesn't matter much how investments perform in the next few months or even a few years. This is true only if the investor doesn't need the capital that's invested in long-term investments. Looking back a decade from now, it won't affect the average return. Unless one is calling for a decades-long global recession/ depression (*which we are not*), it makes sense to continue with a balanced approach in high quality investments. In the process, it is also important not to let volatility affect your emotional well-being when investment prices decline. Price declines are normal – it's the underlying value that matters.

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