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INVESTMENT PERSPECTIVES

The Future is Wisely Hidden

Inflation or Deflation?

There is a growing divide between two “camps” of economists and strategists espousing their respective forecasts for either inflation or deflation with equally strong conviction. As a result, there appears to be a heightened sense of anxiety among investors regarding how to effectively navigate in the current market environment: Will actions being taken by both the monetary authorities (Federal Reserve) and the fiscal authorities (U. S. Treasury, the Obama administration and Congress) to stimulate the U.S. economy result in too much spending and thereby cause sharply higher inflation, or will these powerful authorities do their best to keep interest rates at record lows of nearly zero percent to offset concerns of deflation? In terms of the stock markets, does the recent correction represent an opportunity for investors to increase exposure to more attractively priced stocks or is it simply a sign that the sharp rally that began in March of 2009 has come to end?

Inflation

Following are a few of the reasons why some prominent economists and many individuals believe that inflation is inevitable:

- **Massive Fiscal Stimulus** – Beginning in the fall of 2008 the prior administration responded to the economic crisis by taking unprecedented steps to stabilize the economy and credit markets. Actions taken included passing two stimulus packages, establishing the Troubled Asset Relief Program (TARP) along with trillions of dollars earmarked for similar programs, and taking large stakes in companies in the banking, insurance, and auto industries. A concern by those expecting much higher inflation is that these collective actions were significantly over-done and too much money was pushed into our economy. They anticipate and fear that this overspending will eventually translate into higher prices for goods and services throughout our economy.
- **Monetary Policies** – The economic downturn also led to a drastic monetary policy response. The Federal Reserve slashed interest rates to near zero as the economic

downturn gained momentum in 2008 and have since kept interest rates at that level. Additionally, the money supply has expanded at the fastest pace in 50 years. Given these moves, the Federal Reserve has signaled that its primary focus has shifted, at least in the short-term, from an anti-inflation stance to an anti-deflation position. This significant growth in money throughout the financial system is a recipe for an eventual rise in inflation – the question is not if, but when.

- International Fiscal and Monetary Actions – Central bankers worldwide have reduced interest rates to record lows and governments across the globe have pumped trillions of funds into their national economies in response to the economic downturn. These countries include China, the UK, and France, among numerous others. As a result, there is fear that inflation could potentially become an issue not only affecting the U.S. economy but other major economies around the world.

Deflation

Deflation occurs when falling prices become embedded in the mindsets of households and businesses, causing them to delay spending, investing, and hiring because they believe goods, services and labor will cost less in the future. Such expectations have led economies to a very low level of sustained growth, persistently high unemployment, and to financial hardships for those who have large amounts of debt.

- Recessions and Indebtedness – Deflation has occurred with recessions or after periods of over indebtedness. Excess indebtedness causes a decline in asset values that result in distressed selling to repay loans. Once repaid, the money supply contracts and the velocity of money (the rate at which money changes hands in an economy) is reduced resulting in a fall in prices since there are fewer buyers for the goods and services that are available for sale. The main concern is that even though asset prices have fallen, large amounts of debt remain. Much of the debt is held by banks who must write these loans off their books before they are able to make new loans. There most likely will be additional distressed asset sales that result from this process.
- Credit Problem – While the Federal Reserve lowered short-term interest rates to historical lows and flooded the markets with liquidity, most of the new money has ended up on banks' balance sheets in "excess reserves". Bank lending has collapsed while they have waited for clarity on new regulations. Additionally, they have attempted to preserve capital to offset bad real estate loans and have not identified qualified new borrowers. This lack of new credit in the markets has led to a shut-down of investment and hiring which has exacerbated an already bad problem.
- Housing Glut – Deflation is also a function of excess capacity. We built too many homes and factories in the good times resulting in over supply, but now there is a lower level of demand for these assets causing a significant decline in prices.
- Double-Dip Recession – Core inflation numbers in the United States have recently been below 1.0% and recent GDP numbers have been revised downward. This has led some economists to theorize about the threat of a "double dip recession". No doubt many of

you know how Japan has struggled with deflation for many years. Their “zombie” banks became encumbered with loans to unprofitable businesses (which were not allowed to fail) and thus banks refused to make new loans causing the velocity of money to become stagnant.

One viewpoint is that the United States may avoid deflation because we are extremely flexible and have many self correcting mechanisms that don’t exist in other countries. We have a deep sense of entrepreneurialism that pervades our history. We have a strong Federal Reserve that will react quickly to a decline in the money supply leading to more loan creation. While we may be proceeding slowly, America has a tradition of foreclosure and bankruptcies which acts as a cleansing mechanism to eliminate bad investments in the economy. This is what Joseph Schumpeter, an economist, referred to as “creative destruction,” or the process by which capitalism corrects its mistakes. (The Daily Capitalist 06/29/2010)

How Are We Investing In These Difficult Times?

One of the tenets of our value approach to investing is that the future is unknowable or “wisely hidden.” At the risk of over-stating the obvious the current investing and economic environment is no different. However, it is all too common for investors to prefer to wait until questions about the near future are cleared up before committing. Famed value investor Warren Buffet counters this way of thinking by pointing out that “uncertainty actually is the friend of the buyer of long-term values.”

We continue to invest in stocks and bonds following the same process for making decisions as we have done over the past fifteen years for all of our clients. Our objective is to minimize the downside volatility of each portfolio in both inflationary and deflationary times while achieving satisfactory long term returns for each portfolio.

The core principles we always adhere to regardless of the current macro-economic picture are as follows:

- Common Stocks – We buy only a high quality company’s stock at prices we consider to be quite undervalued relative to our long-term outlook for that company’s prospects. We recommend in most situations that each portfolio own approximately twenty, equal-sized common stock positions which are usually in different economic sectors. We conduct sound, fundamental research to ensure that our holdings meet our high standards of quality and value. Investments in companies which provide value-added goods and services and have the “pricing power” to pass along increasing costs can serve as a good hedge in an inflationary environment.
- Bonds – We buy only high quality issues in equal dollar amounts, usually over an eight to ten year period. Currently that ladder is 10 years. We recommend in most situations that each portfolio have a bond allocation of 20% to 50%. This determination is arrived at during our initial discussions with each client and at any time they or we believe this allocation should be modified for their unique situation. A key reason that we recommend high quality bonds is that they tend to appreciate in periods when stocks are

declining and result in more stable total returns for the portfolio. Also, bonds have historically performed well in a deflationary environment.

In periods of great uncertainty about the future, like we have now, we are particularly excited about finding new attractively valued common stocks that we call 'Best In Class' companies. Characteristics of such companies include the following: industry leadership; strong balance sheets with low or moderate debt; consistent operating and financial ratios over full economic cycles; barriers to entry; and proven management teams. It actually is easier to find great companies at very low valuations in unsettled times like we have now!