End of Year 2007 Commentary

It seems that lately, we have been asked a variety of similar questions from our clients and colleagues. As such, we thought it would be appropriate to address these in our end of year comments.

Are we headed for a recession?
Our simple reply is: ***Who cares?*** We may already be in a recession—certain parts of the economy (housing and autos) are already in a recession (if not a depression). And if the economy as a whole is in a recession—or headed for one—***it is not the end of the world***. Recessions have happened since the beginning of time, and yet, the economies of the world still manage to pull out of them. Over your entire lifetime you will probably see a recession about every ten years. They happen—they are a fact of life—but not the end of your life.

And, as our hero Warren Buffett recently said, ***"some of the best investment opportunities of my entire life happened in the midst of recession."***

In the end, recessions in a capitalist society remove inefficient competitors and reward the efficient ones. Those are the companies we want to invest in.

How long until the subprime mess filters through the economy?
Much has been made of the "sub-prime" loan mess—and it will most likely continue through 2008, if not 2009. As expected, it has affected many things which are not subprime. However, despite the rather dire headlines, only 15% of just the sub-prime loans made in 2006 are actually in default. The rest of the bad news is being manufactured by the media. That is an extremely small amount of ***ALL*** loans made in 2006.

Adding to the confusion is the fact that many Wall Street firms have decided to take an *accounting write down* of the value of subprime loans which are carried on their books. The fact that they have chosen to take an accounting write down ***DOES NOT*** mean that these loans are in default. Most of them are still expected to perform.

All of this will result in a ***slow down in housing and mortgages in the upcoming year***. That is fine. The majority of the slowdown will be felt on the east and west coasts. Texas is actually expected to experience 4% growth. Once again, all is relative and it appears that ***the world is NOT coming to an end***.

What is really going on with inflation?
When Bill Clinton got in office there was a subtle, yet important change made to the way the Consumer Price Index is calculated. The "Cost of Housing" was removed and replaced with the "Cost of Rent". I don't know why this change was made, but it has had a significant impact that has resulted in inflation being ***UNDER*** reported by about 3.5 percentage points a year. Over the past ten years, ***inflation (as originally calculated) has run between 6% and 9% per year***. Anyone who has bought milk, gas, electricity or a house recently will understand this.

After 9/11/2001 the Federal Reserve lowered interest rates to historically low levels. At the same time mortgage lenders lowered their standards. This combination created a perfect storm that had traditional renters leaving their rental property and instead buying property. In simple economic terms this put a decrease in demand upon rental property (which lead to a decrease in rental prices) and an increase in demand to buy dwellings (which resulted in an increase in purchase prices).

Unfortunately, with the changes to the calculation in the CPI this large inflationary shift has not been accurately reflected in our government's inflation figures. ***For planning and investment purposes you need to budget for inflation in the 6% to 9% range.***

What will happen to the dollar?
Unfortunately, the US Government benefits substantially from a low "official" inflation rate. Would the US Government rather pay interest on Social Security, Federal Pensions and the National Debt at the officially stated rate of 2.3% or the actual 6% to 9% rate? If you were a politician, it is not a hard question to answer.

As such, the Federal Reserve is keeping interest rates extremely low in an effort to boost the economy (and save on interest payments, Social Security payments, etc.). When they do that, the simple result is that the US Dollar becomes worth less relative to other currencies. Therefore, ***Fed policy will result in continued weakness in the dollar***. This is fine if you are exporting US goods and services around the world. But if you are going to buy goods and services from outside of the US it will most likely cost more.

What are we doing about low domestic interest rates and higher inflation?
We are taking our portfolios in a slightly new direction that will result in broader diversification. To accomplish this, our clients will see a couple of themes. The first is the ***implementation of broad exposure to commodities***—not just oil and gold—these commodities have become the object of much speculation. We are diversifying into commodities that will give our clients broad insurance against inflation. By doing so our portfolios will have exposure to agriculture (corn, wheat, cotton, soy beans, cattle, coffee, lumber), energy (crude oil, natural gas, heating oil), and metals (copper, zinc, lead, nickel, aluminum, gold, silver, tin).

We will also ***hedge away from the US Dollar by expanding our holdings into foreign bonds and foreign stocks***. There is a big world beyond the US shores and we need to have an intelligent exposure to those assets.

Additionally, most of the US domiciled companies that we do own have substantial international revenue exposure. As such, they give us the desired diversification away from the policies of the US Government.

Where do we go from here?
While our attitudes regarding the financial markets have been tested in the past few months, they have not changed.

We continue to believe that ***emergency money or other funds with a very short time frame should be kept in money market*** or a similar asset. You won't earn much once taxes and inflation are factored in, but it will be there when you need it.

Fixed income assets should be used to satisfy intermediate term needs (one to five years). Again, you won't earn much, but if you stick with good quality, your principal should still be there.

Given all of the market volatility, why do we have this attitude?

	Money Market	**10 Year US Treasury Bonds**
Current Rates of Return	4.00%	4.04%
Minus Income Taxes (@ 30%)	-1.20	-1.21
Minus Inflation	-6.00	-6.00
Net Real Rate of Return	**-3.20%**	**-3.17%**

As you can see, if our math is only approximately correct, investing only in money market or fixed income investments will have disastrous *long term* results.

This is why we continue to believe that ***our clients will receive the most long term benefit from investing in domestic and international stocks***. Although ***the ride WILL be volatile***, it is the one that gives the best opportunity to outpace taxes and inflation over the next 20, 30 or 40 years.

Finally, we thank you for your support throughout 2007 and look forward to a happy, healthy and prosperous new year.

Please call or stop by with questions or comments.

Sincerely,

Dave

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