



August 2011

Splainin'...



Ricardian Equivalence is normally expressed as follows: when the government starts running fiscal deficits, people reflexively consume less in the expectation of future tax increases. Consequently, the fiscal stimulus has no positive impact on the economy.

A variant on David Ricardo's 18th Century concept is illustrated by the experience of a more recent Ricardo, seen above in the chocolate factory. As the line marches on, Lucy and Ethyl resort to ludicrous extremes to keep up. In squaring theory with practice, investors and governments are faced with an increasingly speedy belt.

Handmaiden to this is Keynes' "Paradox of Thrift." While spending less than our earnings and paying down our debts is rational for households and governments, should we all do it at once, a downward spiral develops: our reduced spending means less income for our neighbor, and so forth.

These dynamics are the justification for Quantitative Easing, (QE) the irrigation of financial markets by the Federal Reserve in early 2009, and again last September. Chairman Bernanke's recent assessment of the program this calls into doubt its effectiveness:

"Our policies have contributed to a stronger stock market just as they did in March 2009 when we did the first iteration of this program..."

Note there's no mention of employment or price stability.

To better inform our investment process, we've been listening to what clients are asking.

What happens when Governments default?"

With very few exceptions (Canada, Australia) all countries default. Greece has spent half of the past 200 years in default, and Spain has defaulted five times over the same period. From the Medici till today, lending to sovereigns has had risks. Countries tend to borrow until they can no more, at

which point they have a parley with their lenders. The hazard today is the interconnectedness of it all. The insolvency of Peripheral Europe is a threat not just to European Banks. Roughly one-third of the exposure to Portugal, Ireland & Greece, or \$193 Billion, is in the form of default insurance written by US banks and Insurers. Should defaults trigger payouts on these contracts, the will of the American People to again bail out their bankers may well be tested.

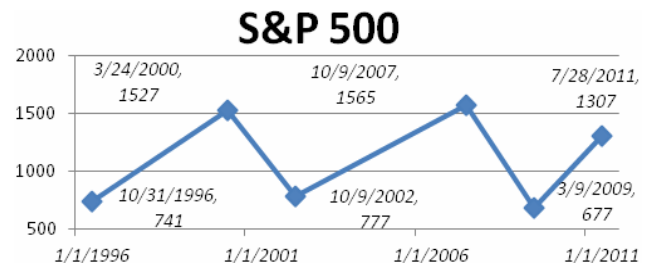
Deflation / Inflation, what gives?

Prices of food and energy are rising, but with employment and housing in the doldrums, along with the dampening force of reduced government spending, the official CPI number may remain restrained for some time.

Unfortunately, an expedient solution to our debt overhang, for individual households and Governments, would be to flush it out with inflation; that is to pay back our debts with dollars worth less. We've done this all long: since 1905 the purchasing power of a US dollar has shrunk 95 percent. "Dollars to Donuts" is an obsolete wager, what was 10:1 is now pushing par.

Offense or Defense?

Both. It's always a good time to grow your principal, but never at the expense of preserving capital. The arithmetic is profound: a 5-year return of zero can be achieved by 5 consecutive returns of zero, or by four years of 10% positive returns followed by one 32% decline.



Though the above chart may imply otherwise, **buy and hold is not a losing strategy.** Buying shares of a good firm, at a fair price, and holding through normal price fluctuations remains a sound and prudent approach, especially if those shares pay a dividend.

The key ingredient here is the price paid at entry point. Many have misunderstood the buy and hold concept, thinking it meant long-term returns were guaranteed if you simply owned stocks for a long enough time period, regardless of purchase price. Discernment is necessary.

A further reason to limit trading is that nobody is perfect: each trade multiplies your opportunity for error. Consider the basketball player with a 70 percent free throw average. His likelihood of making two in a row? 0.7 times 0.7, or 49%. Take it to six attempts (12%), and you see the odds of a misstep become pronounced.

The greatest detractor from our investment performance over the past year has been poorly-timed trades. We recognized the emerging values in stocks during the Lehman crisis, but subsequent further declines tripped protective stop-losses. The positions acquired in mid-2009 had excellent prospects, but again, protective stops the following Spring trimmed our exposure. Most disappointing, a bold out-of-consensus position in Treasury Bonds was twice stopped out at a loss, each time in advance of a meaningful rally.

Our experience with stop-losses is typical of most investors, though we remain convinced of their utility. Absent active risk management, small losses can grow to devastating proportions.

Why Bother with Dividends?

Recall there are three ways to make money owning stocks:

1. *The company earns more, and with a fixed ratio of price to earnings (P/E), your share is worth more.*
2. *As enthusiasm builds for a company's prospects, investors bid a higher price for the firm's earnings (P/E expands), and your share is worth more.*
3. *The company distributes a portion of its earnings to its owners in the form of a dividend.*

Over time, the regular payments of dividends can add up. For years investors have been told a variant on the following: "One dollar invested in the S&P 500 in 1925 grew to \$2,350 by the end of 1998." (*Ibbotson Associates 1998*)

Looking closer, we see the \$1 actually grew to about \$94.65. The remaining \$2,253.55, or 96%, came from reinvesting the dividends and the capital gains on the shares bought with those reinvested dividends. In other words, for every dollar of return generated by capital gain on the original \$1, the effect of compounding and reinvesting dividends generated almost \$24.

That's not to say we can count on the same experience. Dividends of the past were far higher than today, averaging nearly 14% in 1932. The last time the S&P 500 dividend yield exceeded 5% was in 1982, peaking that year at 6.7%. Until 2009, we hadn't seen a 3% yield on the S&P since 1991. The current dividend yield of the S&P 500 is less than 2%.

Where do we invest?

With Bond yields and CD rates at historic lows, barely pacing inflation, the long-term investor is compelled to take more risk than is customary. Where a goodly portion in a money market fund yielding four percent may limit a portfolio's upside, with money fund yields near zero, prudence creates a substantial drag.

As such, we continue to invest in Quality Stocks, emphasizing Energy, Utilities, Healthcare and select Consumer Staples names. Ironically, some technology firms, which often trade more on hope than fundamentals, now pay dividends in excess of the market as a whole.

For the past four years we have shunned shares of Real Estate Trusts (REITs), traditionally a source of robust dividend income. While this caution was validated in 2008, when dividends and share prices collapsed, REIT shares have staged a comeback, though their dividend yields remain well below pre-crisis levels. Absent a marked rise in REIT dividends we continue to avoid these shares.

"Usually a long list of securities is not the sign of a brilliant investor, but of one who is unsure of himself."

Philip Fisher (1958)

We agree, though in these times, a long list of Asset Types is the sign of a prudent investor. Beyond the core of high-quality company shares, we are invested in Precious Metals, Foreign and Domestic bond strategies, and several long-cycle themes which we expect to deliver complimentary returns. In this manner we strive always to have something in bloom in the garden.

Gold and Silver continue to attract investment interest, from individuals as well as sovereign states seeking to diversify away from the US Dollar. While we are thankful for the contribution this investment has made to our returns, the rise of precious metals is another indication of how unwell is the rest of Global Finance.

Despite disappointing returns in Treasury Bonds, we continue to hold two Bond Mutual Funds. These funds have delivered returns independent of the US Stock Market. The domestic long-short bond strategy has shown modest results of late, much due to the manager's reluctance to accept the very low risk premium paid by borrowers today. Our global bond strategy has been delivering excellent returns, as it has for the past decade.

Materials Scarcity is compelling investment theme: own what others need. Volatility in the markets for most commodities, accentuated by the outsized role of speculative capital, has made investing in this space treacherous. We continue to favor dividend paying producers and processors, with a token holding in a development-stage Lithium producer.

Investors could do far worse than simply buy the Southern Hemisphere. With just 10-12 percent of the world's population, countries like Chile, Brazil, South Africa, Indonesia, Australia and New Zealand have a diverse collection of human and natural resources, coupled with a political and fiscal rectitude we can't claim here in the North. We are assembling a basket of Latin and Australasian shares to exploit this.

Where's the Market Going?

Perfect foresight would be a splendid gift. At best, we can assign likelihoods, hope for the best, and prepare for being wrong. Many legendary investors are retiring, a function of aging, as well as fatigue, the most recent being **George Soros**, founder of the Quantum Fund. His parting assessment is illuminating:

I find the current situation much more baffling and much less predictable than I did at the time of the height of the financial crisis. The markets are inherently unstable. There is no immediate collapse, nor no immediate solution.

If volatility is the enemy of confidence, we are besieged. There is a strategy in place: the sails are set, the hold is stowed. We cannot determine tomorrow's state of sea or winds, but we remain ever vigilant of the trim of the vessel. Enjoy your Summer.

Frank J. Ruffing, CFP



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