



July 31st, 2010

Execution

I've long been fascinated by the common human illusion that ideas can be sorted into good and bad, when all experience shows this not to be the case. You'd be hard pressed to come up with an idea so bad that it couldn't succeed with the right execution. And it would be even harder to imagine a great idea that couldn't fail if the execution were left to morons. Ideas are worthless. Execution is everything."

- **Scott Adams**, creator of *Dilbert*.

Take the talent from him and give it to the one who has the ten talents. For everyone who has will be given more, and he will have an abundance. Whoever does not have, even what he has will be taken from him. And throw that worthless servant outside, into the darkness, where there will be weeping and gnashing of teeth." - **Matthew 25: 30**

We cast our net wide for inspiration. While two millennia apart, Scott Adams and Matthew frame our professional endeavor. Dilbert is the philosopher prince of corporatism, while the Parable of the Talents is a seminal text on fiduciary duty, instructing us that that meek and passive stewardship, taking no risk for fear of loss, is betrayal of the basest sort.

In a world of near infinite investment possibilities, and a like amount of opinion, we have one focus: our mandate to compound your wealth.

The Markets

Well, what we are seeing now is a tussle between the 50% sustained speculation branch and the branch where two or three things go wrong and crack confidence. This struggle is an unusual one, and has created market effects I have never seen before, and you have not either. This market might well be called a fearful, speculative market. Low rates, although they tend to produce a feeding frenzy at the aggressive end of institutional investors, merely produce a feeling in ordinary individual investors somewhere between dejection and desperation. They hate to park money in cash at negative real returns, and yet they are still thoroughly nervous, so surveys reveal, about normal equity investing.

-**Jeremy Grantham**, *GMO*, July 2010

Jeremy Grantham has been investing for nearly 50 years. He's currently the G of GMO, a Boston firm advising more than \$20 Billion. In an industry often obtuse, wavering, and woefully wrong, we've found Grantham's perspective acute, steadfast, and mostly correct. He's easy to agree with.

Stocks

High quality stocks were left very much behind in the great rally last year, which was the biggest and most speculative since 1932. Much more surprisingly, they have underperformed this year... But unlike small caps, they have been cheap for almost five years and, given the uncertainties around today, this is unusual.

-**Jeremy Grantham**, *GMO*, July 2010

The notion that Blue Chips, the sort of shares your grandmother may have held for decades, should prevail over time is intuitive and comfortable for two reasons: valuation and dividends.

That value matters is shown by looking at shares of a certain Arkansas general merchandise retailer which earned \$1.25 per share ten years ago. The then P/E ratio of 42.5 valued shares at around \$53 apiece. Over the next decade, earnings steadily grew, around 12 % a year, tripling to \$3.77. All good so far, but the market now pays 13.5 times for those earnings, or \$51 a share. What constitutes a fair price cannot be divined, it is observed. Reversion of prices, though, from extreme to mean, is fair to presume.

Our interest in dividends was piqued years back when our then colleague Dave Rosenberg compared the total return of the Nasdaq 100 and the Dow Jones Utilities index since the birth of NASDAQ in 1971. Remarkably, the "Stock Market of the Future" woefully underperformed Utilities as well as Real Estate trusts. The reason was simple: dividends.

Consider this decade-old study from Morningstar. One dollar invested in the S&P 500 in 1925 grew to \$2,350 by 1998, assuming dividends reinvested. The original dollar grew to about \$96.45, with the remaining \$2,253.55, or 96% coming from reinvested dividends and capital gains on the shares bought through reinvestment. **"For every dollar of return generated by capital gain on the original \$1,"** the authors wrote, **"the effect of compounding and reinvesting of dividends generated almost \$24."**

Mindful of valuations and the miraculous power of compounding dividends, we conclude that stock exposure is best focused on high-quality blue-chip shares. We strive to maintain a balance across industries, with an emphasis on Technology, Resources and Healthcare. Communications and Gas Utilities have excellent income properties, and remain of interest. Our Financials exposure has been limited to a large insurer, as we've found the commercial banks opaque and fraught with risk.

This emphasis on fundamentals has limited our participation in the massive rally in the riskiest shares.

Our Mining and Metals holdings have shown more than ample volatility, and we strive to maintain a collective risk well below "the market." Reflecting on Grantham's description of ordinary individual investors as "thoroughly nervous," and a market environment Rosenberg fairly describes as "a meat grinder," we consider our quality focus appropriate.

In addition to Quality US shares, we are seeing signs of stabilization in European Markets, and remain confident in the Emerging Economies, with a particular focus on peripheral states, the "Frontier Markets."

Michael Geoghegan, CEO of HSBC, recently picked Colombia as a leader of a nascent block of midsize powers, the CIVETS (after the smallish, tree-dwelling cat), which stands for Colombia, Indonesia, Vietnam, Egypt,

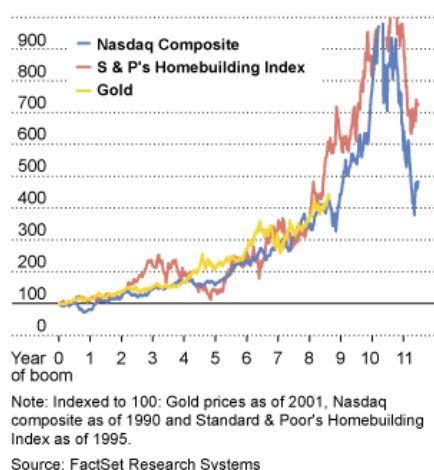
Turkey, and South Africa. "These are the new BRICs," he said. Investing overseas is typically done through mutual funds or exchange traded index funds.

Gold

Gold remains a cornerstone holding. In light of the past decade's advance in gold prices, as it has gone from being a pariah element for those with tinfoil hats to a mainstream investment, it is instructive to review the thesis for gold.

Going Vertical?

The price of gold over the past 8 1/2 years, compared to the first 8 1/2 years of the Nasdaq and housing bubbles.



Gold is a hedge, pure and simple. Ten years ago, as we started buying gold shares, we'd tell clients to hope they wouldn't appreciate, for gold going up means something else is very wrong. If we've learned anything over the past decade, it is that the financial community has an infinite capacity for getting things very, very wrong.

Bonds

The U.S. is closer to a Japanese-style outcome today than at any time in recent history ... a better policy response to a negative shock is to expand the quantitative easing program through the purchase of Treasury securities.

James Bullard, *President, St. Louis Fed, July 2010*

Bonds have proven as volatile as stocks over the past year; state and local governments are deep in the woods; the ratings agencies have proven themselves worse than incompetent, and the market for trading bonds is opaque and rife with manipulation. That said, we hold upwards of one-third of the portfolio in fixed-income securities in three distinct strategies.

Long Term Treasury Bonds are bought not for income, but in anticipation of yet lower interest rates. Deflation is a foreign concept to most of us; the US has not experienced it since the early 1950s, and more famously, during the Depression. As price levels fall, the predictable income of a bond becomes more attractive, and as we've seen in Japan over the past decade, interest rates can settle at unfathomable lows.

Prudence calls for a balanced approach, so we have split equally the bond exposure between Long Term Treasuries, **Foreign Bonds** (mostly governments, via a fund), and a **multi-strategy fund** which can go long and short, with a focus on mortgage and corporate credits. The latter two funds are managed by extremely bright and seasoned bond investors, both of whom have demonstrated a commitment to their clients' best interests.

Execution

Wealth is not acquired through addition. It is acquired through multiplication. Very few fortunes have been made by adding up paychecks and overtime. Nor are they made through a huge one-time killing in the markets. Unfortunately, this is the path that many investors try to follow in achieving financial security. While a high annual income is certainly helpful in achieving great wealth, it is *not* the primary determinant. And while a major move in the market can certainly have an impact, any single move is rarely an important determinant of sizeable fortunes (unless that major move is responsible for wiping an investor out and terminating the ability to continue investing in subsequent years). **John Hussman**, *Hussman Funds, July 2010*

For nearly fifteen years we have served our clients by playing the piano with both hands: Disciplined fundamental research coupled with a respect for the caprice of markets, that is a technical, or chartist overlay. In typical bull and bear markets, the charts would indicate the state of supply and demand, and a well-placed stop-loss could sidestep catastrophe. With the exceedingly short-term nature of the vast majority of market participants, to execute a trade is to expose your capital to a very unruly mob.

It is not "normal" for the broad markets to swing one-to two percent nearly every day, often on extraordinarily light volume. The rise of High Frequency Trading Algorithms and Exchange Traded Funds has disconnected the day to day from long term value as completely as the "Stock Operators" did in the Roaring 20s.

Over the past year we have made a substantial investment in risk management tools. Our clearing brokers are among the most reputable in the industry, and as fiduciaries, our dedication to your interests is explicit. You should expect 100 percent dedication from your advisors, and we strive to deliver that. We cannot promise you an outcome, but we can continually improve your likelihood of success. No weeping and gnashing of teeth. Let's move forward.

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