



January 29, 2010

## In the Long Run...

*Capital moves around the globe like a herd of wild animals.*

**Martin Armstrong**, Princeton Economics

Considering the past decade's events, and reviewing our client's portfolios, our satisfaction with having traversed two epic market bubbles and the greatest financial collapse in generations is tempered by a profound sense of humility.

Our former colleague **Dave Rosenberg**, now with Gluskin Sheff in Toronto, prepared the following table, which speaks volumes about stock market performance over the past three decades.

**Fig. 1 S&P 500 Sector Performance**

| (percent)                | 1980-89    | 1990-99    | 2000-09     |
|--------------------------|------------|------------|-------------|
| <b>S&amp;P 500</b>       | <b>227</b> | <b>316</b> | <b>(24)</b> |
| Energy                   | 162        | 132        | 102         |
| Materials                | 164        | 97         | 25          |
| Industrials              | 185        | 253        | <b>(11)</b> |
| Consumer Discretionary   | 287        | 315        | <b>(21)</b> |
| Consumer Staples         | 564        | 233        | 32          |
| Health Care              | 355        | 353        | 11          |
| Financials               | 173        | 328        | <b>(40)</b> |
| Information Technology   | 71         | 1179       | <b>(54)</b> |
| Telecommunications Svcs. | 132        | 216        | <b>(64)</b> |
| Utilities                | 115        | 38         | 11          |

Source: Gluskin Sheff

**Take a moment to look at what's happened.** Over a ten-year period "the market" lost nearly a fourth of its value. Roll the study back a further fifteen years, and we see from '67 to '82, the S&P 500 producing an average annual rate of return of only 0.2%. Not all generations are dealt the same hand from Mr. Market.

**Simple reversion to the mean** would suggest that the coming years will deliver a more rewarding investment experience. Bear in mind though, the right-most column includes the *astounding* rebound from last March's lows.

Warren Buffet's assertion in 1996 that he "**would much rather earn a lumpy 15 percent over time than a smooth 12%**" has become hard to identify with. Many folks would be happy just made whole.

Experiences like those of the past decade can leave an investor permanently impaired: in terms of reduced capital, as well as in damage to their confidence, the confidence to make decisions, and the trust in institutions able to help.

Mindful of the above, the following maxim has guided our process for nearly fifteen years:

*The avoidance of severe losses, rather than outsized returns, determines investment success over a full market cycle.*

Despite some timely and prescient calls, both on downside risks and opportunities, there is no question that there is more work to be done. Most importantly, we must improve our execution. Marshalling resources, both within and beyond the Firm, we redouble our efforts to deliver the conscientious, creative, and impactful stewardship our clients have come to expect.

## Investment Strategy

*The value of most currencies, including ours, is going to decline in purchasing power. I still believe, over a 10-year period from now, I would much rather own stocks than cash.*

**Warren Buffett** - Financial Times Jan. 2010

The folksy wisdom of the Oracle of Omaha has been a useful guidepost for over 40 years. For good reason: he's been more right than most. What is telling about the above statement is that he's comparing stocks to cash. No mention of Bonds, Commodities, or the arcane Financial Derivatives which his portfolios hold.

We own stocks, and we hold cash. We also invest in securities and funds with differing qualities, including Real Estate Trusts, Bonds and Commodities. Counter-intuitively, our investments for current income tend to be stocks, while we seek capital appreciation from our exposure to bonds.

With current economic conditions depressed, and stock valuations at near-record highs, the **most reliable source of gains from stocks going forward may be dividends**. While not all of our holdings are dividend payers, the selection process favors firms whose management has shown a commitment to rewarding shareholders.

Beyond current yield, the prospects for an increased payout in the future are considered. A company likely to restore or institute a dividend is compelling, as a whole new class of buyers will then emerge.

**Our exposure to hard-asset producers and processors** is unabashedly long-term, and focused on capital appreciation. Diggers, Drillers and Sowers fall

in and out of favor, yet the thesis remains: **own what the rest of the world needs.** We consider Coal, Oil & Gas and the Metals a compelling investment for the decades to come.

*Today, China uses just under six barrels of oil per day for every thousand people. In India, it's about two and a half barrels for every thousand. In the U.S., it's just under 70 barrels for every thousand. Even if you figure just a 20% increase in China and India per person – those are huge, huge numbers.*

**Marin Katusa, Casey Research**

**Gold remains a special case.** While malleable and pretty, it's hard to justify in terms of productivity. But let's refer back to Buffett and his thoughts on purchasing power. In constant dollars, the 1980 top at \$875 per ounce is equivalent to \$2,400 today, roughly double the current price.

The **Emerging Markets**, both large and small, remain compelling, although the "wild animals" Martin Armstrong refers to tend to flee at the snap of a twig. We tread lightly.

To temper the volatility of your portfolio, we invest in areas that may not move in lockstep with Stocks.

**Treasury Bonds remain the most contrarian of our holdings.** While we realized compelling returns in Corporate and Mortgage securities last year, by mid-Summer we concluded that the safe money had been made, sold out, and made a commitment of size to the Long Bond. Our timing was good, yields had backed up from the year-end lows, but rather than taking profits in Autumn, we let the position run, giving back the gains, and then some in the ensuing three months.

Recent gains in Treasury yields (and the attendant decline in prices) reflect a renewed fear of inflation. **There is no substantive reason for Long-Term interest rates to go up, rather a compelling case can be made for persistently lower yields.** Simply put, the hangover from the US debt binge that started in the 1980s will take years to abate. As consumers and firms work off their burdens, they'll be borrowing and spending far less than before.

**Clients of investment advisors may see little difference between being early and being wrong.** To complement our bold, yet disconcerting stand on Treasuries, we've begun to allocate funds to a go-anywhere bond manager who has the both the ability to sell short overvalued credits, as well as the conviction to carry cash when the risk reward is unattractive.

We've also begun to step back into the **Real Estate Trust (REIT)** market, although with a discriminating eye. We have no doubt that Real Estate values, residential and commercial, along with their

associated mortgages, will continue to disappoint for some time.

## Pension?

The table on Page 1 illustrates a real challenge for retirement security. Time was, a worker could expect their golden years to be supported by savings, Social Security, and a company pension. Looking ahead, many are on their own. This doesn't mean we don't need pensions. We'll just have to build them ourselves.

Unfortunately, the amount of savings required to privately fund a traditional pension is daunting. Our work with corporate plan trustees includes thorough actuarial reviews, carefully developed investment policy statements and asset allocation models, yet still we struggle to meet the plans' goals.

For the individual investor to replicate the security of a government, union or corporate pension, her or she will need inordinate thrift, a dedication to prudence, and a terrific amount of good luck. Thoughtful planning can help.

## Rothwise

We've been fielding many questions about the new rules for **Roth IRAs, now available for all households.** This 2010 window, permitting higher earners to convert Regular IRAs into Roth IRAs, may have profound implications for an Estate or Retirement Plan.

More than a few considerations come into play, particularly for owners of closely-held businesses and for those clients who intend to leave a portion of their IRA as a legacy.

We have robust tools to outline your expectations for future tax rates and other factors, and help you determine whether or not such a move is advisable. Roth conversion is not appropriate for everyone, but where suitable, it can make a meaningful change in outcomes.

Looking ahead, we advise prudent optimism. The march of time continues. Let's move with it.

*Circumstances are beyond human control, but our conduct is in our own power.*

**Benjamin Disraeli (1804-1881)**

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