



October 25, 2009

Back to the Garden

Yes! There will be growth in the spring!
Chance the Gardener,
(Being There, Jerzy Kosinski, 1971)

Being There is a fable about a perfect language, one that captivates the listener while revealing nothing of the identity of the speaker.

Kosinski meant his book as a cautionary tale, a mocking of the emerging media culture of the 70's. Despite being illiterate and utterly naive, save what he'd learned through yard work and watching television, Chance's platitudes are divined as supremely wise, and he is embraced by a public starving for common sense. Today we might give Chance a Peace Prize.

You're going to cause the worst financial crisis since the end of World War II
Lawrence Summers to Brooksley Born in 1998,
(Frontline: The Warning (PBS) October 2009)

This admonition to Born, then Chair of the Commodity Futures Trading Commission, was to justify why Summers, Treasury Secretary Rubin, SEC Chair Levitt, and Federal Reserve Chair Greenspan were united in opposing her agency's proposal to regulate over the counter (OTC) derivatives in 1998.

Ten years later, the still-unregulated OTC derivatives market had grown to \$596 Trillion (forty five times the size of the U.S. Economy), and its subsequent collapse placed our country squarely in the worst financial crisis since World War II.

Poetically, a series of interest rate swaps (an OTC derivative) entered into by Summers while President of Harvard wound up costing the University \$1 Billion last year. Betting and losing a thousand million of other people's dollars hasn't hurt Summers: he's now the Director of President Obama's National Economic Council.

You have to -- to exist, you need an ideology. The question is whether it is accurate or not. And what I'm saying to you is, yes, I've found a flaw... That is precisely the reason I was shocked, because I'd been going for 40 years or more with very considerable evidence that it was working exceptionally well."

Alan Greenspan to the House Oversight and Government Reform Committee, October 2008

Naseem Nicholas Taleb, author of "The Black Swan," a seminal study in the failures of mainstream risk management, has a parable that describes the folly of Summers' and Greenspan's discredited legacy. He illustrates it with the following diagram:

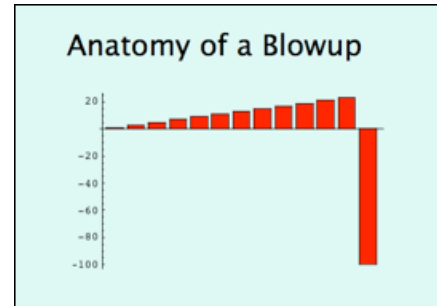


Figure 1 A turkey is fed for one thousand days—every day confirms to its statistical department that the human race cares about its welfare "with increased statistical significance". On the 1001st day, the turkey has a surprise. *(The Fourth Quadrant: A Map of the Limitations of Statistics, Edge.org, September 2008)*

As we look ahead to the prospects for our common welfare, a healthy skepticism of professional consensus may prove justified. Washington and Wall Street are full of well-educated, principled men who have no compunction with dissipating your wealth and that of your children's children.

So let's try not to over-intellectualize, rather focus on simple acts of stewardship. It's Autumn. Thatch, aerate, lay down Lime. Prune, mulch, and get some bulbs in the ground. There will be growth in the Spring.

Investment Strategy

For the first time ever, we have experienced a 60% surge in the equity market from a low over a six-month span in which employment slumped 2.5 million...

What is normal is that after a low we are up 60% three years into the economic expansion and have already created over two million jobs.

So let's get a grip on this flashy but very dangerous rally - liquidity can only take you so far without the fundamentals.

Dave Rosenberg, *Gluskin Scheff*

We've seen no meaningful improvement in business conditions, a precondition for a recovery in corporate growth. Of the three ways to make money in a stock: dividends, earnings growth, and higher P/E multiples, only the last, the willingness of investors to pay more for less, in terms of earnings, has contributed to this rally.

Growth Themes

We continue to invest roughly equally in Hard Assets, Blue Chips, and Emerging Markets. This approach has allowed us to participate in some substantial appreciation, but our quality screens kept us out of some of the moonshot rallies of the zombie banks and allied wards of the State. Our stocks are the sort you buy more of when they go down. The rush for the exits when today's high-flyers turn will be a very crowded trade.

Hard Assets are compelling, because they are real. Minerals, Foodstuffs, Water, Energy and Metals have intrinsic value. A ton of Coal does not go obsolete. Our longstanding commitment to Gold has proven profitable, though the popularity of the metal should give one pause. "Cash for Gold" ads on television ring of Bernard Baruch's taxi drivers and shoeshine boys with stock tips in '29. Recall the last time we saw a popular craze for precious metals, the Hunt Brothers were cornering the Silver market. We remain long Gold, but it's no longer a lead pipe cinch. More recent forays include Platinum and rare metal producers, and in our index allocations we favor greater exposure to Agriculture.

Blue Chips, you know them when you see them. We regard a well-capitalized firm of size, with an enduring franchise, consistent profitability, and a growing dividend to describe this category. A good rule for judging an investment's suitability is would you buy it for someone else? Nearly half the volume on the NYSE these days is in shares of a half-dozen firms once considered Blue Chips. They are now rank speculations no conscientious fiduciary would touch.

Emerging Markets are where investors may reasonably expect to see growth in the coming years. Beyond the Latin American and Asian juggernauts, the Frontier Markets of Africa, the Middle East and the 'stans have promise. Investors are becoming more comfortable with exotic markets, perhaps figuring they're no less safe than at home. Fundamentally, foreign shares can readily be justified; their books are more transparent (IFAS vs. FASB), their boards may more independent, and typically their dividends are more stout. In short, they are more friendly to their shareholders.

Above all, investing for growth should be governed by a vigilance for loss. Art Cashin summed this well the other day on CNBC:

I will tell you this, there is nothing more painful -- ideologically and psychologically -- than being at a banquet thinking that the food is tainted and watching everybody else have a grand old time. It can be a little tough. But if you have strong suspicions about the food, you may feel better than they do in a day or so.

Art Cashin *Director of Floor Operations, UBS*

Income Investing

Most portfolios are balanced with a commitment of size to bonds and other income securities. With the negligible yields on cash, some Utility shares fill this role with a modest risk profile. This Summer we took a position in longer-dated treasuries, which then rallied impressively, despite a torrent of new supply from the government. In recent weeks we've seen a retracement, as inflation concerns picked up. *Until we see evidence of a rebound in employment and the Federal Reserve signals its intention to raise short-term rates*, we are comfortable with this investment and expect it to yield satisfactory risk-adjusted returns.

The discounts in Corporate bonds seen at the beginning of the year have narrowed. In fact, the risk premiums demanded by investors have returned to levels seen prior to the collapse of Lehman Brothers. **It is as if 2008 never happened.** Aside from some short-term high grade credits, we are out of this market.

Discretion

\dis-'kre-shən\ noun 14th century

1 : the quality of being discreet : CIRCUMSPECTION; *especially* : cautious reserve in speech **2** : ability to make responsible decisions **3 a** : individual choice or judgment <left the decision to his discretion> **b** : power of free decision or latitude of choice within certain legal bounds **4** : the result of separating or distinguishing

Merriam-Webster Online Dictionary, 2009.

Regular readers of this letter know we wear our heart on our sleeve, at times to the point of being indiscreet (*def. 1*). Clients hire us for our acumen with regard to making responsible decisions on their behalf (*defs 2 & 3*). The value we add comes from our ability to discern, to separate and distinguish opportunity from hazard in an increasingly precipitous world.

Thank you for this opportunity to serve, and **a special thanks to those who've introduced us as a prospective advisor to others they care for.** Be assured we remain vigilant in protecting your interests, and make every effort to ensure there will always be something in bloom in the garden.

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