



October 7th, 2010

Discipline...

There is one final area in which I think there has been a very definite retrogression in Wall Street thinking. That is in the distinctions between investment and speculation, which I spoke about at the beginning of this lecture. I am sure that back in 1914 the typical person had a much clearer idea of what he meant by investing his money, and what he meant by speculating with his money. He had no exaggerated ideas of what an investment operation should bring him, and nearly all the people who speculated knew approximately what kind of risks they were taking.

Benjamin Graham to the NY Institute of Finance 1947

Had we moved the dates up six decades, and cited Graham's most famous student, **Warren Buffett**, the above quote would ring just as true. At the current rate of retrogression, we may soon expect a return of Silver Bulls, Radio Stocks, and South Seas Investment schemes... Oh.

Among the more repeated aphorisms of Buffett is his First Rule of investing: Never Lose Money; followed closely by his second rule: Never Forget Rule #1. An owner of the Triple A Omaha Royals (2010 record: 81-63), and with Berkshire having lost it's AAA bond rating in the crisis, Buffett knows full well that you can't win 'em all.

Our friend **Manish Chauhan** gives us this interpretation:

What Warren Buffett actually means by "Never Lose" is that every time we lose, it has to be an insignificant loss. The quantum of loss, has to be so limited or small, that it's not going to affect us psychologically.

Rule 1 : Never Lose (Control your losses , cut them soon enough , so that you don't feel them)

Rule 2 :Never forget Rule 1 (Controlling your losses is the top most priority you should have. As long as you are able to take care of it, other things will take care of themselves).

We've long held that **the avoidance of severe losses, rather than outsized returns, is responsible for superior investment results over a full market cycle.** Concern about potential loss may seem out of step with much popular thinking.

Aversion to loss is distinct from aversion to risk. Risk is the handmaiden of return. At present the risk-free rate of return is nil. **Howard Marks** of Oaktree describes the challenge facing investors today:

When the government drops the rate of T-bills to 0.25%, it basically forces people to take more risk. The ultimate safe investment doesn't return anything anymore, so if you want to make any decent money you have to make riskier investments. That's one of the upshots of this government policy on rates...

Selectivity is very important today. If you think about the virtues of an investment manager, what are they? Discipline, patience, selectivity, discernment. That's what you need going forward. You didn't need that last year, when things like discernment and selectivity held you back. You needed capital to invest and guts. Capital and guts are not the answer in 2010 and 2011. The biggest mistake you can make is to not notice that.

The May 6 crash erased \$862 billion from U.S. equities in less than 20 minutes. While the SEC Report would have us believe that a fat-fingered trader in Kansas City caused the evaporation of nigh a trillion dollars of wealth, investors recognize that the tablecloth can be yanked again, at any time, and the dogs will wolf the roast before it hits the floor.

Portfolio

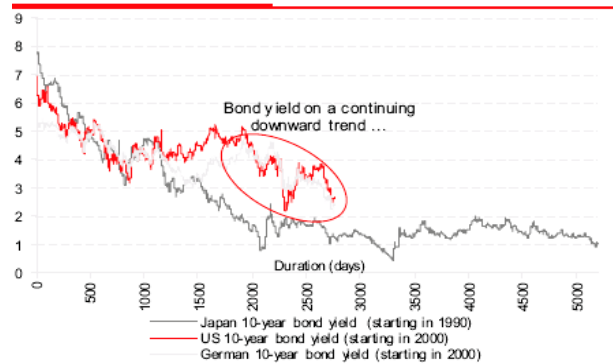
We continue to invest in roughly equal portions of Bonds, Stocks, and Resource Shares / Hard Assets. A good portion remains in cash, admittedly a wasting asset. While we continue to seek good returns on cash, as Howard Marks points out, low rates reflect a government effort to encourage speculation, hardly a compelling reason to speculate.

Bond Market

It's much easier to dismiss it as a "bond bubble" instead of looking at it from the standpoint of a market signal — a signal that the economy is still struggling as it unwinds all the debt and spending excesses of the prior bubble condition.

Dave Rosenberg, Gluskin Scheff

US bond market with 10-year lag compared to Japan



Source: SGI Cross Asset Research

We have relied on Dave Rosenberg's counsel for nearly ten years, and his correct read of the housing and credit bubble helped spare many the carnage which ensued.

Bonds provided outstanding risk-adjusted returns last year, and through the first three quarters of 2010, they have bested stocks (though not Gold). What's underpinned this performance has been the steady decline of interest rates. Until rates stop going down, Government bonds will continue to offer a compelling opportunity for capital gains. As a hedge, we hold through funds foreign sovereigns and a long-short bond strategy. These can be expected to behave quite differently than our Long Dated Treasury Bonds.

Stock Market

We opened the Fourth Quarter at 1,160 on the S&P 500. We first saw 1,160 twelve years ago, in July, 1998 and this is the same level the S&P printed in January of this year. Much heat; little light.



Source: Russell Investment Group, Standard & Poor's, FactSet,

Our friends at JP Morgan note deflationary trends bring to the surface some important questions about corporate profits, which have beaten expectations for the last 5 quarters:

A proxy for profits (nominal GDP growth less unit labor costs) is growing at a healthy clip, which usually indicates recovery rather than recession. Most of the time, a profit proxy of 5% or more reflects healthy nominal GDP growth in excess of still-rising unit labor costs. But the latest profit recovery is reliant on declining labor costs like none before it. **A profit recovery whose foundation is so reliant on sustained high productivity and low real wage growth should not command a very high P/E multiple.**

In other words, if earnings are up due to layoffs and wage cuts, the companies are not necessarily more valuable.

Common Stocks

When selecting individual stocks, we prefer to focus on established brands with exceptional prospects around the World. Themes which have guided our investment process for more than a decade continue to inform the portfolios: the Earth's poor wish to be better off; they will consume vast resources doing so; and this dynamic may stress some existing institutions.

Accordingly we maintain some mining exposure, adding recently to our Energy holdings, as well as buying shares of a global Brewer, and a Consumer Goods firm with a leading position in dental care.

Frontier Markets, the peripheral States of the Gulf, Africa and Asia, have performed well, although recent returns in the Mainstream Emerging Markets have been most impressive. Investors may be embracing the Third World with a less than complete appreciation for history. To see Mexico, China and the Philippines successfully float 100 year bonds, one wonders from what turnip truck the buyers fell.

Gold & Resources

All the price of gold tells you is what paper money isn't worth.

John Roque, *WJB Capital*

Gold continues to be a successful element in our strategy, rallying more than 20 percent year to date. This Spring we switched from gold and Platinum mining shares to Metals Funds (ETFs), in an effort to temper volatility. We continue to hold a junior Lithium miner and Coal in many client portfolios, and we have recently added a Major Integrated Oil producer. Collectively we consider these investments "Hard Assets," in that come what may, natural resources will have value, be it in Dollars, Yen, Yuan, Wampum or whatnot.

Risk Management

The Wall Street Journal recently noted that the number of Americans with life insurance has been in precipitous decline. This is due to many folks' strained circumstances, as well as our industry's focus on tax-management products for the affluent, at times neglecting the basic role of insurance in family income security.

The expiration of the Bush-era tax cuts will undoubtedly make more compelling the advantages of insurance-based tax avoidance, and we are happy to help you assess them (*along with your tax and legal advisors*).

Importantly, take a moment to consider your existing insurance coverage. Have you had a recent thorough review? Is your issuing carrier sound? Do updated mortality tables mean you can get the same coverage for less? Do you need all that coverage, and what is the rationale for the ownership and beneficiary designations?

Execution

There are two kinds of forecasters: those who don't know, and those who don't know they don't know,

John Kenneth Galbraith (1907-2006)

For years we have employed stop-loss orders for managing risk. With the ferocity of today's markets and the unreliability of the exchanges, an investor can no longer trust the liquidity of markets to provide boundaries to exposure.

While we continue to use protective stops, more than ever we are convinced that **a security must be purchased with sufficient margin of safety** that a transient change in price will not shake its holder's confidence. Put more simply, rough roads ahead. Buckle up.

We continue to exercise discipline, patience, selectivity, and discernment. A successful investment manager prospers with his clients, not at their expense. We remind ourselves that daily. Thank you for your continued confidence.

Frank J. Ruffing CFP



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