GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

On Course

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A Storm is Brewing

The stock market is showing signs that a storm is approaching and only those investors who are prepared will thrive when it hits. As you know from our past newsletters, the global economy is besieged with imbalances that we believe will create some fantastic investment opportunities in the near future. Preparation is the key because only those investors who have preserved capital will be able to pick up the future bargains.

Hurricane Katrina gave us an unfortunate lesson in risk management and planning for crisis. Wishful thinking and the inability to fully confront the dangers of an antiquated levee system resulted in what may be our nation's costliest tragedy.

For years, people living in the Delta have been faced with the risk versus the reward of living in a region below sea level. The risk is now clear, but what was the reward? Given that the region is among the poorest in our country, we must conclude that the reward was non-monetary. Perhaps it was familiarity.

In the markets, investors pay a high price for familiarity. They stick with companies that have done well for them in the past, long after the economics of those companies have changed for the worst. These investors continue to own yesterday's winners like Dell, Intel, Citigroup, and Fannie Mae because they are familiar, but will they be winners in the future?

In my opinion, this group of companies symbolizes the stock market.

These companies have expanded credit aggressively so buyers can purchase their goods. They have cut prices dramatically to induce the most budget conscious buyers to commit. They have moved divisions overseas so they can continue to offer low prices. So what is left to sell and to whom?

The S&P 500 Index is trading at 19.5 times earnings for a capitalization rate of 5.1% compared to its historical averages between 7% and 8%. This suggests there is little upside in the market, absent a large jump in corporate earnings. The difference between 5% expected return and 8% expected return is analogous to the market's risk premium, or the extra return that compensates investors for the risk assumed. Fed Chairman Alan Greenspan put it succinctly when he recently said "history has not dealt kindly with the aftermath of protracted periods of low risk premiums".

Returning to the Katrina analogy, the risk is present and the rewards are sparse which is why we retain a relatively conservative portfolio. We're sitting on high ground, waiting for the opportunity to own some great long term stocks at advantageous prices. We'll continue our short term trading strategy, but will do so using very high quality stocks in a disciplined fashion.

Our strategies are working. We've consistently made money all year while the S&P 500, our primary benchmark index, has vacillated between negative and slightly positive.

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Gold

We added to our gold positions because it is clear that Hurricane Katrina will increase inflation in our country. Most of you see this inflation manifested in higher gas prices but the real inflation is when money supply in the US grows faster than the economy. The more money in circulation, the higher prices will be. Our monetary aggregates, the amount of dollars in circulation in the US was growing at 5% before Katrina, but is now growing at 7% a year as a result of Federal government efforts to keep our economy stable following the catastrophe.

It's not just happening in the US. We started to see acceleration in global money supply in March of this year. We have actually seen faster growth in the money supplies of Europe and China. When money grows rapidly, inflation inevitably follows and the best hedge against inflation is gold. We watch money supply growth on a weekly basis, so don't be surprised if we continue to add to our gold positions over the next few months. For a fuller discussion of inflation, visit the publications section of our website – www.geovestadvisors.com.

Energy

Energy is a problem and it won't be easy to fix. The higher gasoline prices we see are largely due to a lack of refining capacity. Refiners were running at 100% capacity prior to the hurricanes, and many will take weeks to months to get back to normal. That output will never be returned to the market. To compensate, and to induce drivers to use less, it's clear that gas prices will remain high for the foreseeable future.

This winter will be particularly difficult on the homeowners that rely on natural gas to heat their homes in the northern part of the country because natural gas prices are almost twice as high as they were a year ago and four times as high as they were earlier in the decade. Notice the chart below that tracks the price of natural gas. It's interesting that the price of natural gas was rising aggressively before the hurricanes.

The result will be a slowdown in consumer spending. We've predicted this before and have been surprised by people's willingness to go deeper into debt but with higher gas prices, higher natural gas prices, higher interest rates, and higher minimum payments on credit cards, there is no escaping the inevitable. We've positioned our portfolios to take advantage of this likelihood.

The Bond Market

Get ready for higher interest rates. The Federal Reserve seems to have recently awakened to the threat of inflation in this country, something we warned you about a year ago. It seems that you can't open the newspaper without a quote from a Federal Reserve official warning that interest rates will have to rise to protect us from inflation. The unfortunate truth is that it's too late, inflation is already here.

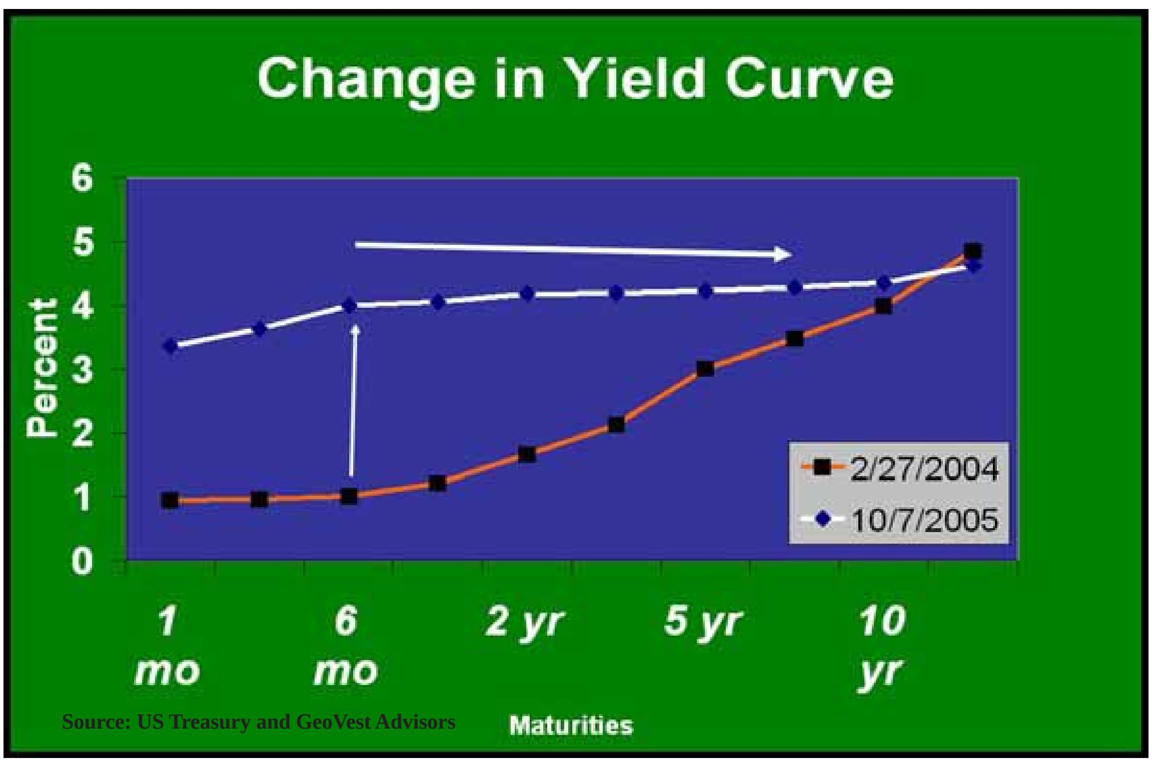
The following chart is the best way to view changes in inflation expectations. Keep in mind that interest rates are made up of two things. The first is the expected level of inflation, while the second is the required return above inflation. The chart of the yield curve, or the list of bond maturities from six months to 20 years, shows that interest rates have risen aggressively between 6 months and 5 years. The 2 year Treasury Bond and the 10 year Treasury Bond now pay roughly the same rate of interest. With inflation getting stronger, why take the risk of buying a 10 year Treasury Bond and locking in low rates for ten years?

The Economy

We are long term investors with a gameplan, so I try to build on different facets of our strategy in each newsletter. In the past, we've talked about consumer spending, excess consumer debt, the impact of the currency on interest rates, and the changing nature of our economy, as a means towards giving our clients a broad understanding of why we own what we own.

In previous newsletters, we chose the "Hollywood Recovery" theme to express our reservations about the sustainability of the economic recovery that started in 2003. We were looking forward because the future will dictate investment returns, not the past. Today, the economy has caught up to our forward expectations and the factors we previously discussed are now working against future growth.

We have an economy that is dependent on low interest rates, but with interest rates rising, the primary driving factor is being nullified. The chart at the bottom of the page is basically telling us that the economy will slow.



The Stock Market

Given higher interest rates, hurricane damage, and rising inflation, our stock market has held up relatively well. The S&P 500, with dividends, was up 2.7% for the first nine months of the year while the Nasdaq and Dow Jones Industrial averages were both negative. Our accounts have done much better.

One of my concerns with this market is that it appears to lack leadership. Typically, leadership in the market is a function of one part of our economy doing particularly well, to the point where companies in those industries are growing earnings rapidly. In the past ten years, our economy has been led by banks, as loan volumes grew, by technology, as we expanded the internet aggressively, by housing companies, as the real estate market strengthened, and most recently, by energy companies, as prices of oil and gas rose. In the past few weeks though, it appears that our market lacks that one hot area that gets investors excited. Since the market reflects the economy, this lack of leadership suggests that our economy is destined to slow down.

As the economy slows over the next six months, it is likely to get a little volatile. It hasn't happened in a while but it's perfectly normal in the equity markets. The key is that if it happens, we are prepared to take advantage of it.

The GeoVest Approach

I believe that the market rewards investors who are prepared and patient. If you are prepared, and willing to make unpopular decisions at the right time, every market can be a good market. As I mentioned at the beginning, we see storm clouds on the horizon but instead of fearing the change, we are looking forward to an opportunity to purchase valuable securities at inexpensive prices.

We've been making a number of positive changes at GeoVest to serve our clients better. In the future, I will update our website when significant events in the world are likely to impact our stock market. If you access our website, you'll notice that I updated it immediately after Hurricane Rita made landfall with an analysis of the expected impact on client portfolios. I hope you will take the opportunity to check out our website and use it as a tool to better understand our investment strategies and how they will affect you, our clients.

This quarter, you will also notice improved graphics in our statements, which are designed to give you a better understanding of the industry exposure that exists in your accounts. This is very important in these uncertain times because sometimes it is not what you own, but what you don't own that leads to strong portfolio performance. Our new statements will make it easier for you to understand these decisions.

Constant improvement in all facets of our business is our goal. To this end, we value the ideas and suggestions from our clients, without whom we wouldn't exist. Thank you and it is our privilege to manage your money.

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