GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

Volume 12, Issue 3 July 2010

On Course

The Plan

Somebody must have left the bear cage unlocked because that nasty ursine troublemaker seems to be back with a vengeance. I'm cautiously bearish in the near term but very bearish over the next couple of years. I don't want to take aggressive action to buy or sell just yet because we're watching the final efforts of global central banks trying to keep the global markets from becoming destabilized. I hold out little hope that they'll be able to maintain stability, which is why I'm planning for one more rally before we "batten down the hatches" in response to an approaching storm.

While I'm hesitant to make aggressive, wholesale changes to the portfolio today, I firmly believe we are facing unprecedented times in the financial markets and our primary goal is to protect assets like we did in 2008 and perhaps grow them if the opportunities present themselves. I use the term "perhaps" because I have no intention of forcing trades, preferring to make moves when they fit our disciplines.

Some Background

It must be stated that the future is amorphous in that small, unexpected changes can have big consequences which is why forecasting with precision is both impossible and a fool's errand. But with that stated, there are some things in life that are inevitable. Cause and effect teaches us that certain actions lead to definite outcomes. There is nothing amorphous about your future if you place your hand on a hot griddle – you will get burned.

With economics, cause and effect can be impacted by extraneous variables in the short run but there is no escaping the long run – eventually it arrives. In our case, the long run has arrived and I don't see any policy trickery or obfuscation of facts that can put off the effects of decades of economic mismanagement by our political class.

Too Much Debt

At GeoVest, we are long term investors in the classic sense. By this I mean that we take positions in stocks that we want to hold for years, not days or hours. To make long term bets, you have to understand the companies you buy. But more importantly you have to understand why the world needs the products they sell as well as how the world will be able to pay for those products.

Eight years ago, I correctly forecasted the "global labor arbitrage", or trend of companies to move jobs offshore to lower costs. The result should have been a decline in consumer spending – fewer jobs mean less spending. But Washington and Wall Street together created our housing bubble that initially allowed consumers to monetize the value of their homes to supplement spending. Since that bubble burst, consumer credit has been

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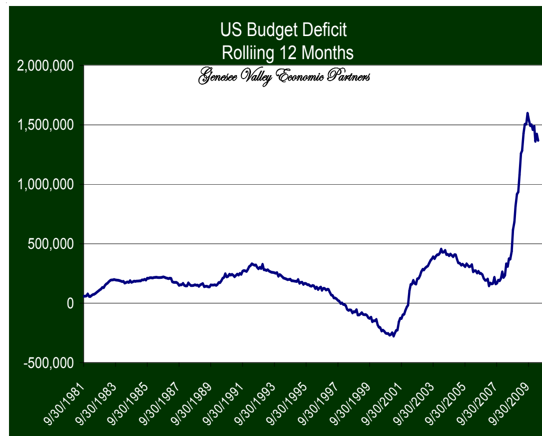
GeoVest Advisors, Inc.
245 Willowbrook Office Park,
Fairport, NY 14450
Tel: 800 - 638 - 5050
Fax: 585 248 8784
www.geovestadvisors.com

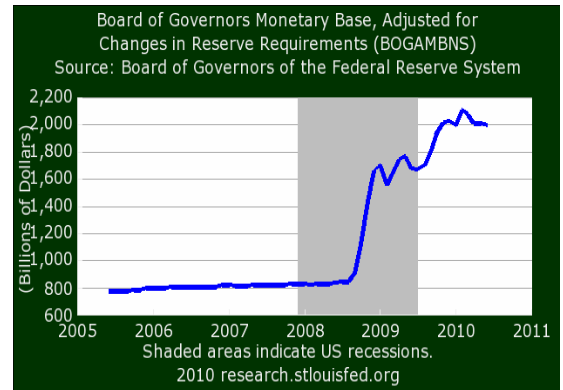
falling. To close the gap, over the past two years, the Federal government has expanded debt by staggering amounts. The problem is that without a real recovery, the US lacks the income to service that debt. Ultimately, we'll end up with the same problems as Europe – a sovereign debt crisis.



Without taxable income, the next crisis appears to be state and local governments unable to pay their bills. California's governor has imposed minimum wages on state workers while Illinois has $4.7 billion in unpaid bills at the end of June.

Now, I'm not so simple as to assume that the Federal government will sit back and allow the states to default – at least not yet. Like the insolvent banks and the housing market, the Federal government will simply borrow money itself and provide "liquidity" to the failed institutions. The problem is that the Federal government already owes a lot of money and without the billions leaving the stock market for the bond market, the Feds would be unable to pay their growing obligations.

At some point in the not-too-distant future, the US government will default on all of that debt but the default won't be in the form of non-payment. I strongly believe that the default will take the form of the monetary printing press. The move may look like the following chart but unfortunately, on a far greater scale.



Gold

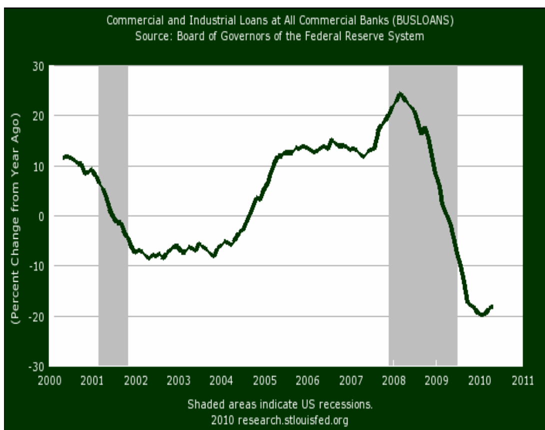
We identified this likelihood as far back as 2004 which is why gold has been our single biggest position since that time. It's had a very good run and we expect it to continue to perform well.

We own gold because we expect the Federal Reserve to ultimately devalue the dollar to make our debts worth less. I have no idea how high gold may rise to but I believe it has the potential to offer extraordinary returns in the future.

If I'm right about gold, then cash and bonds will be terrible performers as they will lose value equivalent to the level of devaluation. We presently have $13 trillion in debt - $20 trillion if you add in the debt of Fannie Mae/Freddie Mac. In addition, I've seen estimates of $60 trillion for unfunded future liabilities like pensions and healthcare. One scenario I'm preparing for is if the government tries to revalue enough to reduce these liabilities in one action – I call it the "nuclear option" because it is an action taken only when all others have failed.

Inevitability

Like most of you, I have an unshakeable belief in the United States and the ability of Americans to conquer any challenge and I honestly believe that we will ultimately fix these problems. But that said, I look at the economy as a combination of effort of 300 million people and I see the majority of our effort being directed towards activities that can't be sustained. Over the past 30 years, we have traded our vital industries for building vacation destinations, restaurants, media outlets, healthcare facilities, and uneconomic housing. In short, we no longer have the assets in place to provide for ourselves, so even if Washington and Wall Street are able to pull-off a miracle that kicks our problems further into the future, there is no way our economy can generate the income to service our rising debt levels. This is especially true when businesses aren't investing in our future. Capital spending, as a percentage of GDP, is at its lowest level in 40 years. This is reinforced by the chart below that shows how business loans are falling at an unprecedented rate.



There is no way our economy can expand when businesses continue to pull back. New investment leads to new jobs and new jobs create the tax dollars that fund government operations. In short, continued contraction is an economic inevitability.

Our Gameplan

This gloomy outlook doesn't mean that we can't earn positive returns on client capital. It simply means that we have to be very careful managing through the tumult that will take place when market participants finally price in reality. We have already added to some of our hedges and expect to reduce our equity exposure before long.

While subject to adjustments, our plan is to use gains from our hedge positions to fund stock selections of companies that fit our definition of "vital activities" at advantageous prices. We anticipate that these companies will perform much better than the market averages.

If we're right that the Federal Reserve will ultimately choose to "devalue" the dollar, we want companies that should be able to raise prices in a hyperinflationary environment. For example, we want to own companies that sell food but frown on companies that sell frivolity like the latest IPOD. The "perfect" company would have high levels of debt that can be "devalued" along with the ability to raise prices so that all the benefits from inflation flow to income. If you look at our portfolios, apart from the utilities, most of our stocks fit this criteria in some form.

In essence, we're managing our equity portfolios like a private equity fund. Private equity funds buy companies outright, getting their returns from the operations of companies, not the mercurial changes in market value as with common stocks. The stocks we are selecting are the ones whose operations are attractive to us given our pessimistic expectations. In other words, we'd be happy owning these companies absent a stock market.

The Bond Market

Our October 2009 newsletter was titled "The Last Bubble" and it appears to be shaping up as such. Money is pouring into bond mutual funds by the billions each week. In meetings, I refer to these funds as "Roach Motels" because I fervently believe that investor money will go in but will never come out – at least not whole.

Bond funds are faced with two huge problems – duration risk and credit risk. Duration risk is the loss in value a bond suffers when interest rates rise. If/when the Fed chooses to devalue the dollar, interest rates will rise aggressively – possibly to double digits and anyone holding bonds maturing five years and over will incur substantial losses.

Anyone holding Greek sovereign debt knows what credit risk is. For those lucky enough not to own that garbage, it's the risk that a borrower will either default on a bond or negotiate a much lower return of principal than previously agreed.

The US Treasury ten year bond has performed very well over the past few months thanks to investors selling their European government bonds and buying US Treasuries.

But I fear that we're following the same path to bond market destruction that has plagued the Europeans. It's why we continue to buy short term US Treasury Notes and Bills despite the relative lack of return. At some point, those people who purchased anything but the safest bonds are likely to lose a lot of money.

The GeoVest Approach

I've used up a lot of space in our quarterly newsletters outlining the problems that we see in the global economy. As far back as 2004, I started explaining our rationale for our investment posture and for the kinds of securities we are selecting. We've remained consistent to that plan, with a few adjustments along the way.

At times, I'm sure our clients were tired of reading about the negativity; I've long since gotten tired of having a gloomy outlook. The reason I've stuck to my guns is because the facts are overwhelmingly pointing to an ultimate resolution to our debt problem.

As well as we did in protecting assets in 2008, I believe we can do better next time. The months ahead are going to bring quite a bit of uncertainty. Ultimately, we're going to experience profound change in our economy but one thing I'm going to keep firmly in mind is that change brings opportunity. By first keeping our client's capital safe, we can look forward to profitable opportunities for deploying that capital. I find myself excited about the future prospects for GeoVest and our clients.

Thank you for investing with GeoVest Advisors. It is our privilege to serve you.

Philip M. Byrne, CFA
Chief Investment Officer

GeoVest Advisors, Inc.
245 Willowbrook
Office Park,
Fairport, NY 14450
Tel: 585 248 5050
Fax: 585 248 8784
www.geovestadvisors.com