GeoVest Advisors

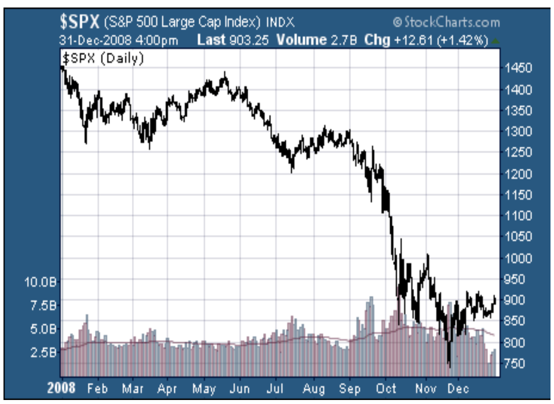
Growing Your Portfolio While Managing Market Risk

Volume 11, Issue 1 January 2009

On Course

The Confidence Game

2008 was the worst year in the markets since the Great Depression with the S&P 500 losing 37% for the year. In many ways, it was worse because many bonds fared as badly as stocks. GeoVest had a spectacular year by comparison as our equity returns were largely flat – anywhere between -5% and up 5% for accounts without restrictions. We also had the vast majority of our clients fixed income money in US Treasuries, which was the sole fixed income category to make money.



We did well because we prepared for the bad environment. We prepared because we dug deep into the economic data reported around the world and discovered many disturbing facts about the fragility of the global economy. Most market pundits will tell you that it was impossible to see this coming; I'm telling you that it couldn't have been more obvious.

The Economy

I've referred to this edition of the newsletter as the Confidence Game because that's the game our government and financial leaders are playing to try to ward off this downturn. It's one part keeping financial markets from falling apart, one part talking about grandiose stimulus packages and one part managing economic expectations by putting the usual band of economic talking heads all over the media. They hope that consumers will continue to spend recklessly while trying their best to inflate another asset bubble.

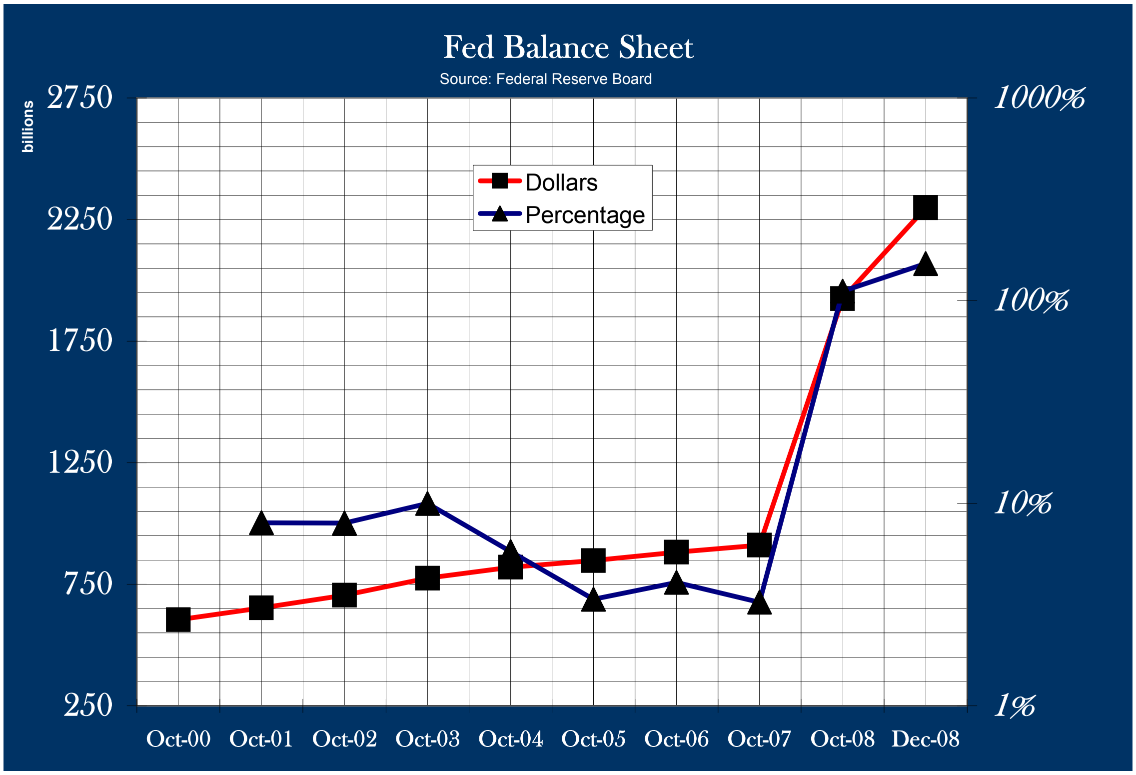
Our economy is falling apart, for want of a better description. Optimism of any kind is unwarranted when you consider the structure of our asset base. Over the past 20 years, we have traded manufacturing and information technology for financial service, consumer entertainment, and healthcare jobs. In short, our asset base is structured for borrowing and consuming, not for long term prosperity.

For most of this decade, we've built enormous homes, far away from our jobs, new mega-stores close to our new homes, and plenty of new businesses designed to entertain us. And to compensate us for the fact that wages have failed to grow on an inflation-adjusted basis for ten years, we've borrowed against the inflated value of our homes, extended the average maturity of our car loans, and run up a mountain of credit card debt.

The whole process was just so ridiculous that it resulted in the destruction of Fannie Mae, Freddie Mac, AIG, Citigroup, Washington Mutual, Lehman Bros., Wachovia, Bear Stearns, Countrywide, and Merrill Lynch, to name just a few of the most obvious. The government has become the de facto source of credit for much of America but look at the result.

Table of Contents

GeoVest Advisors, Inc.
245 Willowbrook Office Park,
Fairport, NY 14450
Tel: 800 - 638 - 5050
Fax: 585 248 8789
www.geovestadvisors.com



The Federal Reserve is providing unlimited amounts of money to keep the major financial institutions in this country from imploding. We believe the unintended consequences of these actions will be hyperinflation, which is why we are major proponents of gold, and also why we're unwilling to buy long dated bonds.

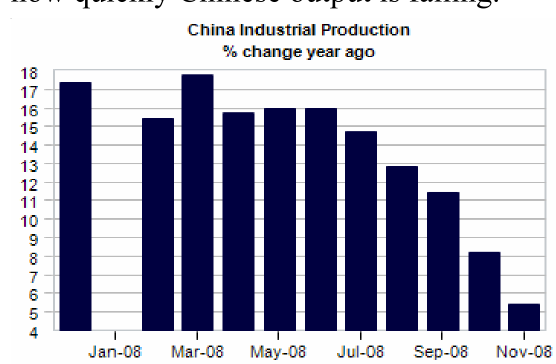
But despite essentially giving money to the major financial institutions – more than $300 billion to Citigroup alone – credit is being restricted to broad swathes of our economy. Given that we need somewhere between $5 and $8 of new credit to create $1 of economic growth, there is no way we escape a deep downturn.

Presently, there is some optimism about the incoming President's fiscal stimulus package which should result in spending of around $400 billion for the next two years on infrastructure improvements and rebates for the middle class, among other largesse. Those are big numbers but when you do the math, it only equates to around 3% of our total economy – it sounds nice but its effect will be negligible.

The plan gives people hope, and while misplaced, it's still a building block. The US will ultimately pull itself out of this downturn, but the stimulus plan will have had nothing to do with it.

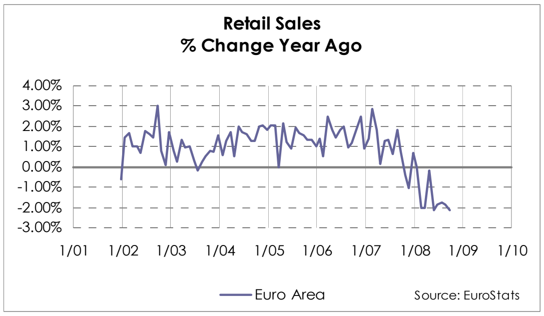
The Global Economy

The good news, if there is any right now, is that the rest of the world is getting hurt worse than we are. China's economy is decelerating rapidly, just as we anticipated. Anecdotal evidence suggests that workers are moving back to the countryside as manufacturing plants are closed. The following chart shows just how quickly Chinese output is falling.



Source: Economy.com

Europe hasn't escaped the global downturn as retail sales are falling rapidly. Other measures of economic activity such as industrial production and confidence are also weakening in Europe.



The reason why I'm relatively sanguine about the global economy is that the rest of the world has structured their domestic economies to supply us with consumer goods. The US will suffer as retail stores, restaurants, and cell phone kiosks are closed across the nation but places like China have to shut steel mills and other heavy industrial properties. Once closed, US plants won't have to compete with them.

The Stock Market

It would be tempting to suggest that 2008's weakness has provided us with a great time to buy stocks but I'm not going to do that. Instead, I believe we are in a multi-year Bear market for stocks, one that will leave us with stock prices much lower than the already discounted levels. I base this conclusion on two factors. The first is that stocks represent the returns that management can generate from their asset base. In the worst global economic environment since the 1930's, what returns can be generated from any asset base?

The second is the mix of assets that I alluded to in the economic section. Our asset base is levered to supporting consumer activity and the consumer is out of money. Retail sales will fall on a multi-year basis, and corporate profits will suffer.

But before you start hollowing out your mattress to stash your savings, please keep in mind that at GeoVest, you're not invested in the market index. You have stock in companies that we believe will benefit from the present economic environment. Economic downturns change priorities. For all the companies experiencing declining demand, there will be new companies that take advantage of the new realities. In other words, it's possible to make good returns during market downturns.

The Bond Market

The correct way to read this chart is by yield, not price. Basically, this reflects that the interest rates paid on ten year Treasury Notes has fallen from 4.25% down below 2.5%.

I view US Treasury bonds as the final asset bubble. Prior to last summer, our clients were happily invested in short term US Treasury Bills, the safest investment on Earth. But now, everyone has jumped on the bandwagon and we can't find bonds that pay us for the risk that is still inherent in the bond market.

Given the Federal Reserve's attempts to "reflate" our economy, at some point, Treasury bond rates are going to rise dramatically. Whoever owns these securities will lose a lot of money.

But this brings us to the question of where to put fixed income money? Right now, it's best to wait for greater opportunity. If we're right about the hyper-inflation part, interest rates are going much higher, which means that locking in longer dated maturities would lead to losses.

The second consideration is the state of the economy. Outside the US Treasury, there are very few entities where we can be confident that we'll get our money back. At a minimum, I want to wait and see what year-end financial statements look like before committing fixed income money to anything other than Treasury bonds and the strongest municipal government debt.

The GeoVest Approach

In true contrarian fashion, I find myself getting more optimistic about the future. For years, we've been telling you that something bad was going to happen with our economy and now that it's here, we can pick up the pieces and deal with it.

We expect enormous change in our economy over the next ten years. Our political elite are hard at work trying to maintain the status quo of a consumption-based economy but the damage is too extensive; life support is the best case scenario. People are starting to save again and that's the first step towards recapitalizing America.

A lot of people lost a lot of money with Bernie Madoff and his ilk. They lost money because they bought the hype but ignored the substance. By substance, I mean risk/reward. Hedge funds, money center banks, and Wall Street firms generated big returns by risking client's money by using leverage. These charlatans had a few winning years where their risky strategies paid off – for them. They got all the upside through outrageous fees while clients ultimately held all the risk. In a way, it was like cheating on an exam because they got high marks with little effort, until the test was changed.

At GeoVest, our goal is to provide clients with the highest level of return for each unit of risk we embrace. You know what you're getting because we have our composite returns verified by the outside accounting firm of Mengel, Metzger, and Barr – something that few investment firms choose to do. In addition, all of our client's money is safeguarded at either banks or brokerage houses, so there is no chance of a similar situation occurring with our clients. We prefer it that way.

Our goal is to grow the value of our client's accounts through good times and bad – the key is to anticipate the bad times before they hit. Success will be a function of finding good businesses at attractive prices that do well in this particular operating environment. GeoVest Advisors is a good business that has distanced itself from the competition over the past ten years. We get stronger with each new client that joins us. If you are happy with your returns and your service, please recommend us to a friend. If you are not happy, we would like to know why because at GeoVest, we never forget that 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 8789
www.geovestadvisors.com