GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

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On Course

Rough Times Ahead

Four years of preparation is paying off because we forecasted and prepared for this crisis. Most of our accounts are flat on the year, compared to a 20% drop in the S&P500 index through 9/30/08 and far more since. And despite the crisis, I'm confident of the future because we are preparing for the next phase of our nation's economic expansion instead of trying to salvage ravaged portfolios. Preparation will be the key because our economy will be dramatically different from the past five years.

Changes in the market generally precede changes in the economy which suggests that rough times are ahead. As I've written in past newsletters, this downturn will likely be one for the history books; that can already be said for financial firms. As our economy has been driven by obscene lending decisions in the past, most everything built by those lending decisions will crash. Last week's $700 billion bailout package was the equivalent of a quarterback throwing a "Hail Mary" bomb at the end of a football game, only to fall ten yards short of the endzone. In our judgment, too much damage has been done to the banking system for $700 billion to fix; there is too much bad debt on bank's books. It's the reason banks won't lend to each other.

As I write this letter, the market has already passed judgment on the legislation and doesn't like it. The only thing left to do is to manage the downside risk, and prepare for the inevitable good times to follow.

Gold

The price of gold has gotten extremely volatile over the past year. On the one side, you've got investors like us who believe in its prospects. On the other side, you've got speculators, largely hedge funds that are purely interested in short term price movements.

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I'm as excited about the prospects for gold and gold mining stocks as I can be. Sure, the hedge funds are still selling – they have to because many are going out of business, but physical gold – coins and bars – are becoming very difficult to find. People are buying gold because it will protect them from the upcoming global currency devaluation. I've written about this before, but it's worth repeating. The only way to prevent the loss of purchasing value is to buy securities that rise in value and gold has historically worked.

The Dollar

Take the $700 billion, plus the additional $100 billion of pork in the latest bailout bill. Does anyone believe we've got that money in the US? Our current account deficit is running at a $700 billion per year run rate before the bail out. It could move to $1.5 trillion or more before this crisis is over. Will foreign governments continue to support the dollar in the face of this massive savings deficit?

Notice how the dollar has been a flight to safety these past few months.

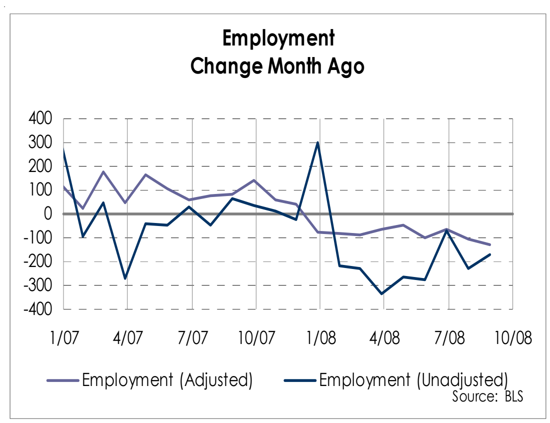
Call me skeptical, but I believe that we're going to try to attract every penny from around the globe before we devalue the dollar. It's the reason I love gold and why I'm warming up to oil again.

Economy

Consumption-based economies, especially those financed by foreigners, are inherently unsustainable. They are unsustainable because the upper limit on our ability to consume is what we earn, plus a temporary increase in debt that ultimately takes away from future consumption. It was fun while it lasted, but it's over and any attempts to resuscitate the victim will only prolong the agony.

Foreign investment is fine as long as the capital is being invested in profitable enterprises such as factories but not so fine if it is just supplementing consumption. That's because consumption doesn't produce future cash flows. Foreigners have been supplying us the money to gorge ourselves on excesses while making us invalids by doing all the things we once did for ourselves. Unfortunately, those foreigners weren't smart enough to demand real value in return for their products.

Recent US employment trends show that jobs are still being created in areas such as healthcare, government, and leisure, but not in core areas such as technology and manufacturing. In addition, we've lost jobs every month this year and it would be worse if not for the liberties the statisticians at the Bureau of Labor Statistics are taking with the numbers.



I view employment as a great indicator of our future output potential. From what I can see, we have an overabundance of health clinics, restaurants, and Bed & Breakfasts, but not enough real industry to drive our economy.

The result is going to be a deep recession. The Wall Street talking heads are looking for a bottom in the economy and the market; I'm looking for conditions to put capital to work. From my vantage point, we are a long way off from the bottom.

Healthcare

As I mentioned, the US has been steadily adding to healthcare investment to serve the retiring baby boom generation. Since the government picks up more than 50% of each dollar paid to healthcare providers, and since they have promised the baby boom generation first-rate healthcare, the industry has thrived. Yet, you won't find many healthcare stocks in our portfolios because the industry is far too competitive.

In healthcare, if you've got a great idea, you'll have six copycats before your product is commercially viable. Notice the chart for healthcare stocks.

Normally, in times like these, healthcare would provide an excellent "flight to safety", but no more.

Financial Crisis

It's painful to listen to the talking heads discuss the origins of the financial crisis and who's to blame. At GeoVest, we were very early in forecasting this crisis. Our firm has spent countless hours talking about the topic, modeling it, and understanding the nuances. There is a long list of people who are obviously to blame, with Alan Greenspan sitting at the top, but in the final analysis, we, as a nation, are all culpable. We elected the people who made it possible – from both parties – and we lived a lifestyle that was just a little too far above our means.

I expect this financial crisis to get much worse because the number of bad loans in the system is a moving target. The weaker our economy gets, and it will get much weaker, the more bad loans will surface. The reason I want to stay as far away from bank stocks as possible is that I fervently believe that our banking system will need to be recapitalized. By this I mean that a large amount of shareholder equity in bank stocks will be completely wiped out, never to recover. Only after this happens, and their books become transparent will I commit client capital to the banking industry.

International

A year ago, everyone who had an international mutual fund was considered brilliant. Today, those people are receiving condolences. Personally, I view those former savants as being the same fodder that got swept up in the Internet rage. I know how much time I spend studying global economics and still not feeling prepared enough to buy into many of those countries, yet I read countless advertisements from so-called investors telling me that international investing was a way for me to reduce risk.

I'm still skeptical because I adhere to the Warren Buffet view that "knowing what you own" is the best way to reduce risk. Sure, I was forced to regurgitate Jacob Maslow's efficient market thesis when I was in grad school on how buying a broad basket of securities from other countries can reduce risk, but I never believed it.

As they say in the baking trade, "the proof is in the pudding." There is a reason why all the global stock markets are falling today and the reason is that the overindulgent extension of credit allowed the global economy to grow as it never should have. The price of copper in Peru, the price of a home in Las Vegas, and the price of a factory in Shanghai were all a function of the same thing – bad lending. Now, they are all falling for the same reason – banks will no longer make loans – for good projects or bad.

Notice a chart of the Shanghai Composite.

It's down over 60% this year. If you bought it in 2006, you've done well, but if you bought it in 2007, you will need the help of your tax accountant. The main point is that it is falling for the same reasons why the Dow Jones, Euro Top 100, and Brazilian Bovespa are falling.

So did diversification reduce risk?

The GeoVest Approach

Warren Buffet is telling people to be "greedy when others are scared." Baron Phillipe Rothschild once said to "buy when there is blood in the streets." While both gentlemen are/were extraordinary investors, too many people are using their words to make investment mistakes.

The markets have fallen in value; in some cases quite dramatically, but it is still too soon to start wading into the blood on Wall Street. In my opinion, now is the time to preserve capital while preparing for a far different economy when we finally escape these negative times.

Trade protection and a move to the left politically appears to be in our future. Re-establishing competitive advantages versus our trading partners is the path to prosperity, and investing in those companies that will make this happen, is the future for GeoVest and our clients. It's too early to determine which companies will be right for investment, and besides, the market value of corporate America is still too rich from our thrifty perspective.

Attractive rates of return are a function of finding the right properties and paying the right price for those properties. In the future, Ben Graham's value investing theories will be in, while Jacob Maslow's diversification theories will be out. Grad schools will start teaching students how to build valuable companies for long term growth instead of teaching them how to hide problem assets using derivatives. In short, the future looks pretty bright.

We welcome any feedback from our clients on how we can serve you better because at GeoVest, we never forget that serving you is our privilege.

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