



On Course

GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

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Toxic Bond Worries

A long time ago, I learned the truth that every credible money manager learns, that Wall Street investment bankers don't have our client's best interests at heart. Their main purpose is to sell securities to the public and to earn a big commission doing so. Wall Street research is in place to support the sale of securities. It's the reason why we go to great lengths to understand the investments we make as opposed to relying on that research. With this as a backdrop, it's easy to understand why the current mess of repackaging bad loans is about to blow up on everyone involved.

As I've been writing about for the past few years, the economic recovery that started in 2003, the one we've called "the Hollywood Recovery", has been a function of lending money to people and businesses that will never pay it back. Reasonable investors would never provide the money that backs these loans, so Wall Street took these loans and amassed them in securities called "collateralized debt obligations", or CDO's. With help from bond ratings agencies like Moody's and S&P, who get paid by Wall Street firms, not by investors, they were able to convince managers to buy these bonds.

But this scheme wouldn't have worked if not for one more ingredient and that is the asymmetric incentive system of hedge funds. Hedge funds generally charge a 2% fee for managing assets, plus 20% of the gains over a certain benchmark. Because their fees are outrageously higher than traditional managers like GeoVest, they have to take enormous risks to justify

their services (yet we outperformed the typical hedge fund in 2006).

CDO's are perfect for hedge funds thanks to their illiquidity. Unlike a US Treasury Bonds which are widely traded throughout the world, CDO's rarely trade in a secondary market so there is no reliable price data. This means that hedge fund managers "mark to model" at the end of each reporting period. Another way to say it is that they get to determine the price of the CDO's they own and thus, their own "outperformance." Given the huge incentives they have to report strong returns, does anyone believe they provide conservative estimates?

The proof is in the proverbial pudding. Bear Stearns recently had two of its hedge funds "blow up" from owning these toxic bonds and when they tried to sell them, buyers were offering 30 cents to 80 cents on the dollar, or 20% to 70% losses. Unfortunately for the Bear Stearns investors, the fund manager borrowed between 5 and 10 times the value of their investments to buy more of these toxic bonds. This is what is known as "using leverage." The result is enormous losses that Wall Street appears to be trying to cover up.

Many on Wall Street have been following a similar strategy and I suspect that many funds are technically insolvent where the value of their assets is below the value of their liabilities. Stated differently, many investors have probably been "wiped out" and just don't know it yet. A number of

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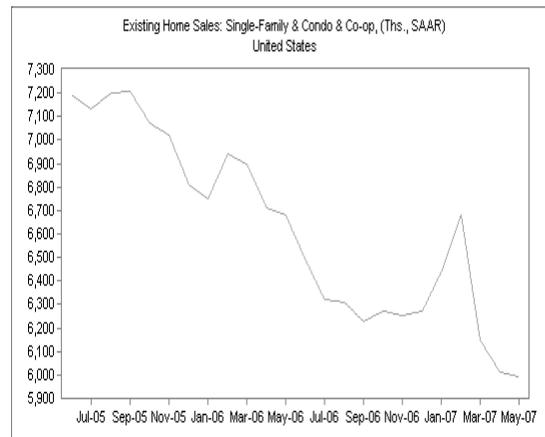


funds have already moved to restrict investors from withdrawing their money.

The financial shenanigans that are currently taking place would have been incomprehensible to me a few years ago, especially given the vast amounts of information that is now at our finger tips. But the truth is that consumer spending, which is 70% of our economy would not be growing without these financial shenanigans and that is the reason why we've tried to stay conservative in our portfolios the last few years.

The Housing Market

Our anticipation of falling house prices remains the correct analysis. Prices will continue to fall until people can afford them without aggressive financing. It took very aggressive financing techniques such as the ones that ultimately ended up in the aforementioned CDO's in order to put people into houses they are unable to afford. The result is a 90% increase in foreclosures and over 2 million homes currently sitting empty.



Source: Economy.com

Notice the chart provided. The housing boom peaked exactly two years ago and has been falling ever since. Official statistics suggest that home prices have remained firm but anecdotal evidence from reading newspapers from all over the country suggests that prices may be down 20% to 30% in many locales.

The bad news is that we are still early in this downturn and it will get much worse before it gets better. The good news is that we anticipated this reversal and are invested in areas that aren't exposed.

The next shoe to drop, so to speak, will be the negative impact on banks and mortgage companies when they are forced to sell the real estate that they foreclosed on. This will force many of these banks to take losses on assets that were previously booked as gains. From this discussion, it should be abundantly clear why we have no current plans for adding new financial service investments to client portfolios.

The Bond Market

We are currently reaping the benefits of our gameplan in our bond portfolios. A few years ago, we made the decision to buy only ultra high quality US Treasuries and Municipal bonds. While early, we are seeing the benefits today as corporate and more exotic bonds decline in value.

Around a year and half ago, we decided to allow our longer dated bonds to work towards maturity while all new purchases focused on the six month to one year maturity levels. We're generating very competitive returns and doing it with relatively little risk – the best of both worlds. And, unlike Bear Stearns and Merrill Lynch, there is actually a market for all the bonds we have been buying.



The chart provided shows how interest rates on long term bonds have risen from 4.6% at the start of the year to 5.20% currently.

The next year is going to be very tricky for investing in bonds. On the one hand, we continue to forecast a slowing economy, yet slower growth generally favors long term bonds. We also continue to forecast a sharp drop in the value of the US dollar which generally leads to higher long term interest rates.

Ultimately the decision comes down to expected returns in bonds. Today, short term bonds pay the same rate of interest as long term bonds. Without some form of compensation for the added risk, why buy long term bonds?

The Stock Market

The stock market has had a nice rally since it's weakness in late February which is odd given the slowdown in the economy combined with higher interest rates. Pundits attribute this strength to the leverage buyout (LBO) craze gripping the world along with the perception that the global economy is growing strongly. Regardless of the reason, I'm pleased because our accounts continue to perform very well.



Yet, I'm not pleased with the fundamentals that support the market, therefore, we remain patient when adding positions believing that most stocks continue to be grossly overvalued given our position in the business cycle. We continue to like oil and gas, defense, gold miners and some agricultural names and we continue to avoid financial services, technology, and most retailers, the exception being supermarkets.

LBO's

Most of us remember the leveraged buyout mania of the late 1980's where corporate raiders became household names. Those days are back, sans the corporate raiders. Today's buyers are called "private equity funds" and they are willing to pay top dollar for companies that would never make it into our portfolios at current prices.

The winners of this mania are the private equity funds and the shareholders of the companies being purchased while the losers are the investors buying the bonds of these companies. I say that because bondholders are the only ones bearing the risk of these deals as the private equity funds will charge enough fees to get much of their initial investments out leaving the bondholders holding the risk for a nominal interest rate. In my view, this is dumb with a capital "D".

The Economy

Most analyses that I read from mainstream economists focus on predicting some number for gross domestic product growth, as if a single number tells the whole story. At GeoVest, we focus more on the composition of growth as opposed to the arbitrary number that is generated after numerous statistical assumptions.

From our vantage point, the economy has weakened noticeably. We track a wide assortment of disparate measures from

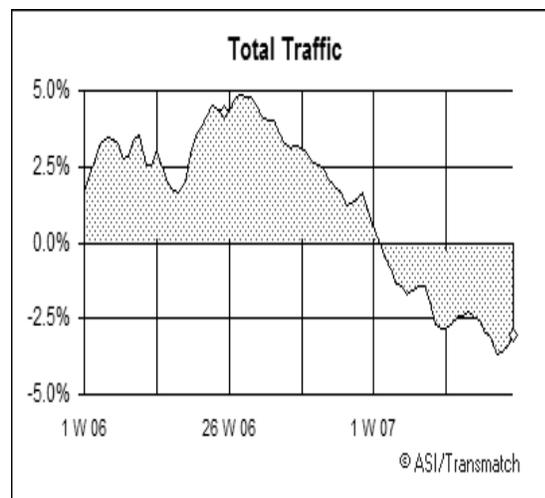




government statistics to company results to traffic on US railways. As much as possible, we try to validate each important piece of data with observations from other sources. This way we can generate higher levels of conviction in our strategies.

The official statistics are telling us that the economy is poised for recovery following a very weak first quarter of 2007. Manufacturing and retail sales appear to be improving from weak levels.

Unofficially, we see no sign of impending strength. Manufacturing jobs continue to be lost, retailers are reporting tepid results, and trucking/rail/port volumes are down from a year ago. We also know that mortgage equity withdrawal, the backbone of our economy for the past few years, has declined considerably, which suggests that consumers don't have the liquidity for making purchases like last year.



The chart provided shows the annual change in rail traffic. Since economic activity requires the movement of goods from place to place, this chart suggests that our economy has weakened since the beginning of the year.

Beyond that, gasoline prices and food prices are cutting into consumer's pockets as well as real estate taxes. Returning to the official statistics, we have strong

evidence to suggest that our economy has produced far fewer jobs than is being reported. While pockets of strength, even extreme strength, still exist, we find ourselves far less sanguine about the current environment than most. Throw in our negative expectations for the housing market and the rationale behind our cautious stance becomes unassailable.

The GeoVest Approach

With a few relatively minor exceptions, our gameplan for our portfolios is playing out beautifully. We've anticipated many of the problems plaguing our market while benefiting from the opportunities that we've foreseen. Our strategy that combines "anticipation of the future" with disciplined valuations has been a powerful approach that has allowed us to earn strong returns with relatively low risk.

We don't favor low risk as a permanent posture but building a portfolio is like building a house, you start with a strong foundation. For the past few years, the foundation of the market has been exceedingly shaky given the economy's unhealthy dependence on debt and an artificially inflated housing market.

We'll continue to invest with discipline to both grow and protect client portfolios until that time when fundamentals give us the green light to assume a more aggressive posture. Thank you and it is our pleasure to serve you.

Philip M. Byrne, CFA
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