



On Course

GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

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Sub-Prime Worries

The stock market had a rough first quarter, with the S&P 500 growing a mere 0.64%, primarily due to concerns over the sub-prime mortgage market. Notice the sharp drop we experienced in late February into early March.



If you've been following the story, you know that an alarming number of borrowers are late on their payments and even in foreclosure. For some odd reason, this seems to have caught the market by surprise, but it shouldn't have because this has been the most glaring example of financial excess that I've ever seen – including the Internet bubble.

The Hollywood Recovery

The problems that are surfacing in the sub-prime area were the basis for our Hollywood Recovery theme in our 2004 newsletters and it is the reason why we've maintained a relatively low risk equity portfolio since. We identified the start of these problems in 2003 when we observed that banks were giving loans for houses to unqualified applicants. Unfortunately, we

didn't realize that it would take three more years before the rest of the market became aware of these problems. The discipline of managing this risk cost some upside in our portfolios but it has left us both confident and prepared to grow portfolio values even as the rest of the market starts to panic.

Housing

The whole rise in housing over the past ten years has been built on the unsustainable foundation of lending money to people who will never repay it. The markets are currently in the process of reversing this mistake which will result in a large drop in the number of people who are eligible for mortgages, even as much as 30% compared to last year.

Making matters worse, the US has gone on a home building spree of epic proportions, leaving us with far too many homes for the reduced number of potential buyers. The result will be a large drop in the value of homes, likely to levels below those seen in 1997. This price erosion will likely be stretched over the next five years.

The chart on the following page shows the price history of US housing when adjusted for inflation. It should be clear that our recent rise in home prices is an aberration unlike anything we've experienced over the past 100 years. Notice how the boom years of the 1970's pale in comparison.

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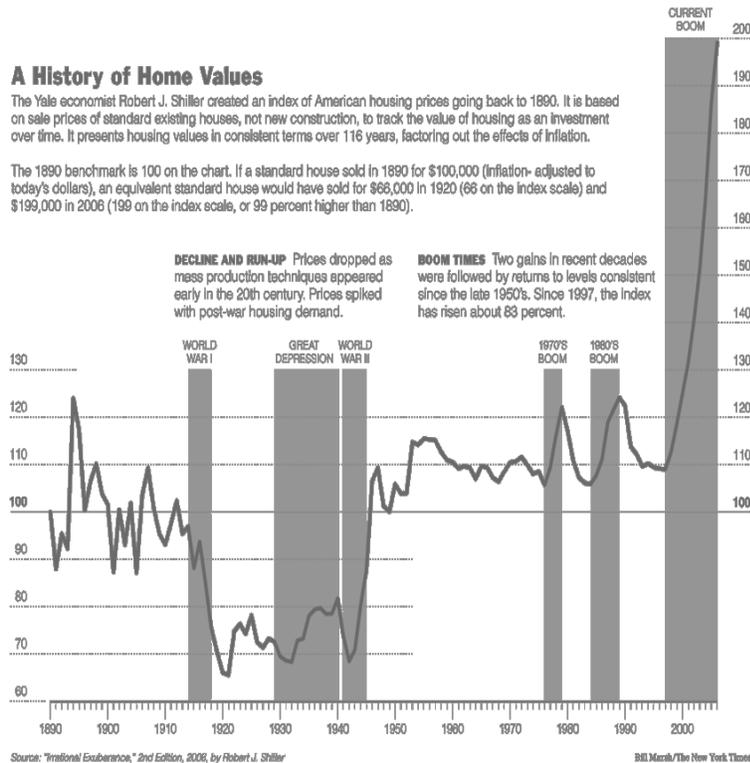
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A History of Home Values

The Yale economist Robert J. Shiller created an index of American housing prices going back to 1890. It is based on sale prices of standard existing houses, not new construction, to track the value of housing as an investment over time. It presents housing values in consistent terms over 116 years, factoring out the effects of inflation.

The 1890 benchmark is 100 on the chart. If a standard house sold in 1890 for \$100,000 (inflation-adjusted to today's dollars), an equivalent standard house would have sold for \$66,000 in 1920 (66 on the index scale) and \$199,000 in 2006 (199 on the index scale, or 99 percent higher than 1890).



Opportunity Abounds

We're in an odd position where we are negative on the market, due to the aforementioned impact of the housing market on the economy, but very positive on the stocks we own. Perhaps the best way to describe this inconsistent situation is to say that the conditions that underlie the industries we like are so strong as to likely transcend any negatives that might occur from a weakening economy. We currently like defense, oil, gold, natural gas, electricity, and supermarkets.

We don't know if there will be an escalation of military conflict in the Middle East, but the conditions are ripe for it. Many people don't appreciate just how tenuous the Iranian President's position is. Mahmoud Ahmadinejad, and the mullahs that back him, are at risk of being overthrown by their own people

because the Iranian economy is literally falling apart despite high oil prices. Nobody wants war, but if you want to hold onto power and nothing else works...

Oil is the reason we won't abandon the Middle East and with recent news that Mexico's giant Cantarell field running out of oil (discussed in prior newsletters), we need the Middle East even more. As much as we are averse to expanded military conflict, the chances of it happening are strong enough to warrant future growth in our defense budget.

In past newsletters, I've written about peak oil production, the point where the world will never produce as much oil as it does today. We're close, if not already there. The General Accounting Office of the US Congress has recently written about this likelihood. The rising scarcity of this all-important commodity may

allow for some very strong returns in the oil industry. While we already have a lot invested in this area, we may buy more.

We continue to like gold despite anemic returns for mining companies. The problem has been that the cost of mining gold has risen as fast as revenues from higher gold prices. Our bet has been that the price of gold would rise so rapidly that it would outrun higher costs, leaving these companies with growing profits.

Natural gas stocks are still attractive, especially after a delayed, but cold winter used up a big part of their excess inventories. A hot summer could make these stocks jump.

Electric utilities have continued to perform well, but they are too expensive to buy new positions.

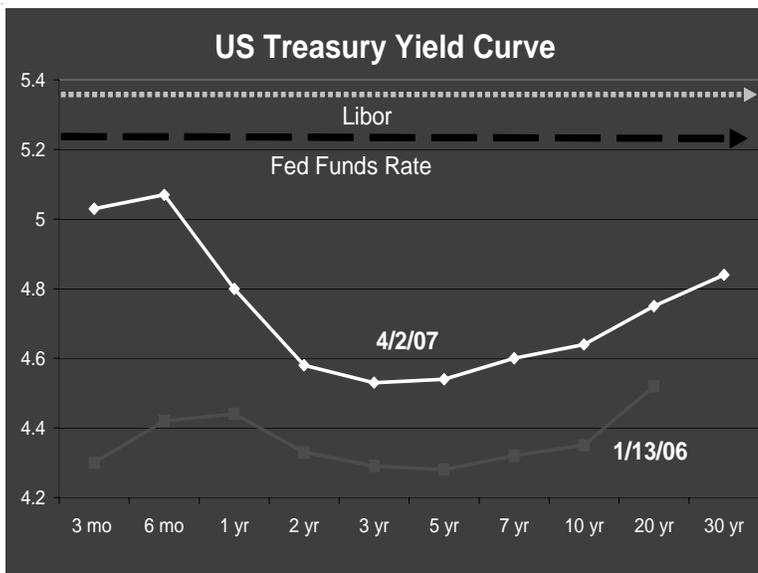
Finally, supermarkets have been our anti-WalMart play for the past few years. When things were going right at WalMart, they were able to offer lower food prices to draw shoppers into the store where they could also buy soft goods. Now that people aren't buying soft goods to the same extent, WalMart can't subsidize food and it is taking competitive pressure off supermarkets.

The Bond Market

In our last newsletter, we discussed the tremendous complacency in the bond market right now, especially with investors who buy the toxic garbage coming out of Wall Street in the form of Collateralized Debt Obligations and Structured Notes. I'd wager that most people who buy this paper have no idea what they are buying.

As an investor who likes to "know what he owns", I have a particular aversion to these so-called investments because they are profitable for Wall Street, and if they are profitable for Wall Street, they're probably not going to be profitable for me as an investor. Sure, they offer higher yields than treasuries, but will you ever get 100% of your money back at maturity?

Notice the chart provided below that shows that short term interest rates continue to offer higher yields than long term interest rates. Given the uncertainty in the world, combined with my expectation for a much weaker US dollar, I continue to believe short term Treasury Bills paying 5% are the smart place for client's money.





Emerging Markets

The hottest mutual funds are the emerging market funds that invest in countries such as Brazil, Russia, Argentina, China, and India. From the chart provided below of the Morgan Stanley Emerging Markets Fund, you can see where the returns have been spectacular.



Retail investors, institutional investors, and hedge funds have been piling into these very illiquid markets to the point where foreign investors dominate the individual markets. The result has been a mania every bit as torrid as the Internet boom, more so if you consider that hedge funds have used leveraged trading strategies to maximize the returns in these markets. But like every other mania, it's the early investors who make money. The investors who join the party late are more likely to lose a lot of money – just ask condo flippers in Florida last year.

In my opinion, these markets are dangerous because very few “investors” have any clue regarding happenings in these countries. Besides, unlike a reasonably valued stock on the NYSE, there will be no buyers for the securities in these funds when the crowd decides to get out.

There are some legitimate growth stories such as China, but each country poses enormous risk ranging from slower growth to disastrous national economic policies. Only the savviest investors will be able to get out when the time is right because historically, when emerging markets go bad, the downward move in prices is generally fast and brutal.

The GeoVest Approach

George Santayana once said: “Those who cannot remember the past are condemned to repeat it.” I believe we are currently at the end of a credit cycle – a cycle where too many people have borrowed more money than they will ever be able to repay. It's not the first one in history, nor will it be the last. It's unique from the standpoint that most of the credit creation has taken place outside the banking system, thus making it harder to identify.

I wrote a piece a year ago forecasting the current environment and how it will affect the global economy. Much of what I forecasted a year ago is coming true. If you're interested, it is called *Trouble Ahead for the Global Economy* and can be found in the publications section of our website, www.geovestadvisors.com.

I believe we have identified the important variables to manage through this cycle and that our portfolios are well-positioned for the future. Based on our expectations for changes in the markets, we have a gameplan for the next ten years, and I believe those years will be very rewarding for GeoVest and our clients. Thank you for investing with GeoVest. It is our pleasure to serve you.

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