

Dichotomy & Hypocrisy – Two Greek Words

The history of the Greek people and their homeland is ripe with beauty and education. Many contemporary cultures have derived words from the Greek language. Two such words are “dichotomy” and “hypocrisy,” which we can look at more closely to see how they apply to today’s socioeconomic atmosphere.

- Dichotomy – a division into two mutually exclusive, opposed or contradictory groups: a dichotomy between thought and action.
- Hypocrisy – a pretense of having some desirable or publicly approved attitude:

Greece has negotiated to reduce their outstanding debt by asking bond holders to accept a 70% reduction in value. This reduction, plus other measures, is intended to save Greece from default and exiting the EU. I would say a 70% haircut is a pseudo default when coupled with the terms given to new bond holders. Their new debt levels are now 120% of GDP, and in my opinion will not prevent more problems and Greece still having to leave the EU as early as 2013. The dichotomy exists between people who can count and people who rub their hands together and hope. The hypocrisy is the expectation that the other troubled nations will not want the same type of deal. Portugal, Italy, Ireland and Spain (part of the PIIGS nations of debt) are all floating down the same river of debt denial. Spain is trying, as they just announced their biggest austerity plans since the return of democracy. Let Greece default – the moral hazards are not worth the domino effect that will soon follow of other nations re-negotiating for similar terms. America let Lehman fail, based partly on this moral hazard.

Mr. Market: 2012 has started strong, with equity markets posting double-digit returns in the face of global uncertainty. How can this dichotomy be? My answer is fundamentals, because companies are still making widgets and people are still buying them. For every demand, there is someone, somewhere, filling it. This is why capitalism is flourishing even in communist China. So the trick is determining in what part of the world to invest and into what widgets. With such low interest rates as what we are seeing around the globe, I believe there are more dangers in owning certain types of bonds than there are in owning equities. In previous newsletters I have written about the search for yield, and this opinion has not diminished during the current quarter.

Energy:



Energy has been one the most important investment sectors and an area in which I am continually researching. Energy exposure has increased recently, leading me to conclude that we are entering a tipping point. Let's briefly highlight energy investing, as I believe no other sector better represents the dichotomy of supply and demand. Hypocrisy creeps in to the topic when we look at our actions on each subject.

Oil & Gas: For the 1st quarter of 2012, I have made incremental purchases into energy yielding investments, as I believe the current environment nationally and globally is trending toward this sector. I have been purchasing individual names and exchange-traded funds (ETFs), as well as closed-end and open-end mutual funds. The funds I have been selecting have underlying investments in limited partnerships that if I were to own individually would expose my clients to K1 filings and other nuisances. Because the manner in which these funds are structured, the investors are able to gain exposure to this asset class without having to receive K1 filings. Client CPA's are happy and so am I, especially with the healthy yields these energy investments provide. We added SteelPath Partners to our outside manager list for their energy exposure, as I like their back story and portfolio management style. An additional bonus is that under the Schwab no-load platform, my clients don't pay the 5.5% front-end sales charge, since we are able to purchase with no upfront or backend load as long as we hold the investments for 90 days.

The short-term tail that is wagging the oil dog seems to be Iran and the effects of a trade embargo. Iran is the 2nd biggest producing member of OPEC. India and China are still buying Iranian oil but that appears to be slowing, and Iran has limited choices for refining their specific type of oil. Two additional pressures on Iranian oil is that the insurance costs for shipping have skyrocketed, and they are about to be shut out of their [SWIFT](#) money trade system with other nations. Shell, as I write this article, is struggling for ways to pay the Iranians \$1 Billion that they owe for shipped oil.

Americas' strongest trade partner is Canada, so I have added Canadian based Penn West Energy to the portfolio (PWE), as they appear to have a great reserve and capacity to extract oil at a profit. Who knows how politics will play out, but I am willing to bet that the world will still need oil. Also, as more consumers become accustomed to the \$100-per-barrel price, the more likely prices will remain high. Saudi Arabia has been using their excess cash to settle down their domestic citizen issues and not investing in added capacity, so they cannot easily overproduce to compensate for a worldwide shortage. Oil is used for a multitude of finished products, from plastics to food products, but is overwhelmingly used for gasoline, and the world is making more vehicles.

***Education note:** a term you might have heard regarding oil, “Light Sweet Crude,” refers to oil with less than 0.5% sulfur and is the type typically found in Saudi Arabia. It is excellent for refining into gasoline and diesel. When you hear the price quote on a barrel of oil, it is typically based on West Texas Intermediate aka “Texas Light Sweet.” And why is diesel not more expensive than regular gasoline? Diesel has higher taxes per gallon, plus an increase in demand for clean diesel and its fuel efficiency has led to capacity restraints. Also, Europe is no longer exporting, instead keeping their supplies for their own domestic need. Lastly our US refineries were hurt by Hurricane Katrina.

The Milken Institute is a non-profit organization, of which I am a member, that has done some remarkable work on energy awareness. ([see Milken](#)). In a Milken Institute report cited by Jon Huntsman during his presidential campaign, the true cost of gasoline is \$13 a gallon when you analyze all the hidden costs to support troops and other expenditures for the protection and transport of oil interests. Every US President since Jimmy Carter has made speeches on US energy independence, yet we still import 57% of the oil we consume, and 70% of it is used for transportation. I have had the pleasure of meeting with, and talking to, T. Boone Pickens on this very subject, and I like his plan of switching our truck fleets to natural gas, which is abundant in America (see [Pickens Plan](#)). Recent Superlotto fever gripped our nation, and T. Boone took the opportunity to let Americans know \$640mm = 11hrs of OPEC sales.

Many nations use gasoline tax as major source of revenue. Let’s take a look at how this position translates into our two Greek words for the day. Italians currently pay \$9.17 per gallon with half that cost in taxes. The Italian Government has raised the taxes to a point where less people are driving which translates into; less toll road collections, less commerce for consumers and a lower quality of life for Italian citizens.

The US increase in domestic production has led to collapse of Natural gas pricing, and based on America’s current energy situation, it seems we have been exposed to the same Greek words, dichotomy and hypocrisy. Natural gas is as cheap as it has ever been, and still we don’t have a way of promoting this abundant domestic source. As an environmental realist I like natural gas as a source but am concerned about what the process of [fracking](#) does to the water tables. Plus I am not happy that the EPA allowed a backdoor piece of legislation that allows drillers to hide the ingredients they use in the process. I believe that domestic natural gas is a work in progress, but I also think that a domestic energy policy is economically and militarily critical for the survival and strength of the US. I am hopeful that natural gas becomes a major component of our energy policy. One idea; change our subsidy policy for energy producers and shift those dollars into converting traditional gasoline stations into offering natural gas.

Nuclear: Following the Japanese Fukushima nuclear meltdown, it appears that new construction plans are being severely limited around the world. Japan had 54 reactors running prior to the 3/11 tsunami, and now only two are running pending further investigation. The US currently has 104 nuclear reactors, which provide our nation with 20% of total electrical output, and the next new plant is not scheduled to go online until 2020 (source: World Nuclear Association). I am first and foremost a realist, so I don't fall into the camp of those who want to abandon all nuclear energy, and this opinion comes from someone whose whole house runs on 32 solar panels. In 2009 I was at a symposium on nuclear energy whose speakers were comprised of some of the field's top international experts. I walked away from this symposium thinking that nuclear energy could grow globally, and that maybe the time was right to invest, but in the back of my mind I said one disaster would put a brake on growth. I still think nuclear is a viable energy source, but it's like the fabled Greek story of Icarus who ignored warnings and flew his wax wings too close to the sun. Where do you store the nuclear waste? For how long can plants designed for 40 years continue to be extended, and how do you dismantle them? And how can you prevent by-products from being weaponized? [Current technology](#) uses a dirty fission process, but maybe someday there will be a breakthrough in fusion.

Coal: Coal [generates 54% of US energy and is the single biggest polluter in our nation](#). Why do you think America has not ratified the Kyoto Protocol? America, China and a good portion of the rest of the world still use coal as their main power source. China alone accounts for 50% of worldwide coal consumption. It will cost untold billions to retrofit all the smokestacks to make them less polluting, and there is no rush to get this done in a challenging economic climate. [The US Coal industry likes to brag about how they are a 70% cleaner product than they were 30 years ago, but most of that was because of legislation they bitterly fought against](#). Berkshire Hathaway purchased railway Burlington Northern, and I am sure they looked at the numbers from coal transport and how much it contributes to their annual revenue. Warren Buffet is a long-term investor, so I am betting that coal is going to be a mainstay of our domestic energy needs. China is investing in Nuclear, solar and wind because they know dirty air from coal is hurting the health of their citizens. Dichotomy; the world runs on cheap abundant coal, Hypocrisy; we know that it's bad for earth's living inhabitants.

Alternate Energy: As a personal passion, I subscribe to numerous news articles and continually search for alternate sources of energy. Because I am an Alt Energy Geek, I have researched how to build my own solar panels and windmills. I believe in the coming decade that improvements in solar energy will lead to truly market parity choices, devoid of subsidies. So with all this passion and belief toward alternate energy, I still have not made any significant investments in this area. Why not? Because I believe we are still in the early stages of this cycle, and I think this type of investing is best done with the venture capital/angel investing and private equity groups. I believe the potential for many alternate energy strategies is enormous, but

arriving at profitability will take some time. Hemp has proven to be a great bio-fuel crop, certainly better than corn, but the US has a political issue with hemp and this issue is ripe with Hypocrisy & Dichotomy. Fuel from algae is also promising but will take time to go from the lab to the gas tank. The one area I pay closest attention to is the storage of energy, and in particular batteries. Some real [breakthroughs](#) are happening in batteries that I believe in the next three years will lead to new products. My favorite story in alternate energy transport remains [betterplace.com](#) and their partnership with Renault. Please take the time to learn how this simple solution can change our driving and energy habits. Betterplace CEO Shai Agassi, [battery change demo](#) and [company](#). Added note for clients in Southern California; I have a good source for anyone looking to add solar panels to his or her home or business – just reach out to me and I will forward their contact information.

Not everything this quarter is about energy, as we made some nice purchases in the real estate sector using real estate investment trusts (REITs). We have added several names to the portfolios that I like based on their management styles, current yields, valuations and potentials for growth. Starwood (STWD) was paying a 10%+ yield and trading for under their current net asset value (NAV) when we first started buying. I have had the opportunity to meet and discuss real estate with Barry Sternlicht, CEO of STWD, and I have an appreciation for his valuation methods and the patience with which he deploys capital. Other names in the REIT space include Apollo Commercial (ARI) and Lexington Realty (LXP), both of which I purchased based on their balance sheets, current yields, potentials for growth and better valuations. I am pleased with these purchases so far as I continue to monitor them closely. I found Amerco (UHAL) based on an REIT yield search for public storage PSA.

Sincerely,

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