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"All That Glitters, is Not gold"

Taken from Shakespeare's 1596 work, "The Merchant of Venice", this expression of glittering clearly speaks to us over five centuries later. In this newsletter I will re-trace some past observations and also discuss moving forward in today's market.

I have written and spoken for quite some time about Gold as a currency proxy for fear. Nothing has changed with my opinions;

1. Gold has very little productive value. Gold's main uses are in currency and jewelry due to decreasing quantities used for electrical conduction. Warren Buffet has commented many times on how a pile of gold will still be the same pile years from now. Gold does not generate revenue like a company.
2. Human's <u>fear</u> and <u>greed</u> are the basic premises guiding many of our decisions. The fear that Governments will collapse and paper IOU money (Fiat currency) made worthless has led investors to embrace Gold as an alternate currency. I have always argued against this notion. I believe a true panic would result in the increased sale of canned beans and ammo. How or who is going to buy gold if we have a world collapse?
3. I have had the privilege of meeting with Steve Forbes as he discussed his views of how America moving away from the gold standard was a mistake. I disagree with Mr. Forbes on this issue as I believe modern economics would no longer support physical backing of issued debt.
4. Bubbles come and go. Gold is (or was) another bubble much like Tulips, DOT com companies and Real Estate. Why would gold go down in price if the world was volatile? If anything gold should go up in price in this climate. My opinion is that gold has value, but the price must be reflective of true value and not speculation. Can the price go higher or lower? Yes is always the answer, but do not expect logic to be part of the equation.

Bonds – As I have been discussing for my entire career, you should not invest in anything until you understand the relationship of bonds. Bonds are the crux of almost all my investment decisions based on 30 years' experience as an investor. Why own stocks if I can get AAA US treasuries yielding 10% or more? Why would anyone pass on locking in AAA 14% yields for 30 years? The easy answer is <u>fear</u>, because inflation was rampant and short-term bonds were paying more. In October of 1981 30 year treasury yields stood at 14.68% compared to a yield of 15.39% for 3 month CD's. The ultimate expression of that fear is that when US Treasuries were yielding double digits the vast majority of investors placed money into Short-term CD's or money market instruments instead of locking into 30 yr rates that were yielding less. Why lock into long-term when short-term had more flexibility and paid more? I am a bit of a finance geek so several years ago I taught one of my interns how to create a master Excel chart showing the major yield indices for the past 30 years, month-over-month. I studied the correlation of yield because it is a critical component of total return investing. Unfortunately the Government sometimes meddles in what is taxable which complicates the job for financial advisors.

I used the services of an outside website www.buyupside.com to calculate the total return of the S&P 500 index with dividend reinvested from Oct 1981 to Oct 2011. The 360 monthly observations, culminated for a total gain of 828% equaling an annualized rate of return 7.73%. In the prior example locking in a US AAA Treasury @ 14.68% would destroy the total returns of stocks. I won't even get into the psychological comfort of sleeping at night not having to worry about volatile investments as you hold AAA debt. Plus, there is the added benefit of higher and more predictable cash flow.

So by this comparison am I saying that bonds are better than stocks? Not at all. What I am specifically saying is there are times to be a Borrower, Buyer and a Lender. When you buy a CD or Bond you are a Lender. When you owns Stocks, Private Equity, Real Estate you are a Buyer. And when rates are favorable you are a Borrower. This is why I shudder and get a little angry when I hear of the magic formula between stock and bond ownership is calculated using someone's age minus 100. There is NO FORMULA other than the simple fact that you take what the market will give you. If the market is giving you low rates don't invest in long term bonds. If stocks are yielding at a significant spread to US Treasuries and the dividends are tax advantaged then look at stocks.

In the last three years I have spent a great deal of time talking about how difficult this market is on my retired clients and also for those looking for a balanced portfolio. Hopefully every client has re-financed any of their debt to take advantage of low rates. Recently, within a period of days the US 10yr Treasury bond rallied from a 1.65% yield to almost 2.6%. In my world this is a HUGE move in a short-time. Put another way, if you were someone that purchased into a 10yr yield note you have a paper loss of 60% on your AAA bond in a matter of days.

My actions towards owning bonds and yield oriented investments;

1. I have sold off most my clients longer maturity bonds, focusing instead on shorter maturities.

2. Most of bond funds have Short-term Duration. Duration is a slightly complex formula but low duration is what you want to own if you thinks rates will go higher.
3. I have been a buyer of Senior Bank Loan funds which re-set their rates to borrowers when rates rise. In a rising rate environment this is a type of investment I would want to own, but during the recent bond pullback these Senior Loan funds went down slightly in value. How can this be? Back to that emotion <u>fear</u> as the average investor uses this trait more than logic. Sell everything that has the word "bond", is how a panicked investor reacts. This is also where my opportunities begin.
4. In my opinion rates will not skyrocket. I think the US 10yr Treasury will range from 2.25% to 3.50% for 2014. If my predictions come true, then these would still be incredibly low rates.
5. I will continue my work on yield oriented equity investments. I believe they are still some of the best areas to own now and for the foreseeable future.

In past articles I mentioned a few clues I look for in a recovery. To recall these were;

I. Housing Sales
II. M&A Activity
III. Jobs
IV. Government that is Business Friendly

Housing is a crucial component to a US recovery because it touches so many industries and employees. While we have proven that the stock market can go higher without housing, I think the fundamentals of our economy are much stronger with a healthy housing market. I think logic will return to investors as they adjust from a ridiculously low rate they were recently quoted to the still incredibly low rates available today. Ask anyone you know what the rates were for most of their house purchases and the majority will tell you 6-10%. In conclusion I am not willing to loan anybody money for 10yrs at 2.5% but I sure would be a borrower…if you qualify? This is where opportunity exists. The recent strategy by hedge funds and intuitional money to purchase single family homes was right on the target. These sophisticated investors took advantage of low rates to buy depreciated assets. Use scale and you get leverage on costs. Currently we have national housing shortage as inventory is very low in most cities and bidding has once again risen. I like owning REITS in this economic environment, but have yet to purchase a pure play REIT for single family homes.

Mergers and Acquisition (M&A) activity has certainly picked up from anemic levels, but Thomson Reuters says M&A's are weaker than at any time since 2009. Rates are low but everyone is scared to part with their cash or use new issued debt. HJ Heinz, Virgin Media, and now Dell are mainly due to an understanding of a balance sheet in a low rate environment.

Unemployment numbers has improved declining from 9% to 7.6% in recent years. These economic numbers cannot be manipulated as Jack Welch once proclaimed on Twitter, "these Chicago guys will do anything..cant debate so change the number". I don't agree with Mr. Welch but I do believe Phantom Numbers exist in the true reflection of jobs in America. For examples; The Phantom number of unemployed who are no longer looking for work, the Phantom number of people scamming the system who are not earnestly looking for a job or in some cases dead participants receiving benefits, The Phantom number of employed people receiving cash without paying taxes still using the resources of the city in which they live.

Government that is friendly to Business has become a critical component of investing in a hyper-sensitive market. I am a known critic of partisan politics so I am equally ashamed of both parties. In the disaster movies my sons loves to watch, in the end nobody cares if you're a Democrat or Republican when the meteor is heading to New York. Side Note – why do all the disaster movies wipe out NY, it's never Chicago or Paris? In the last 4 years it seems as though our leaders would continue arguing over who gets the life jacket when the 150' Tsunami wave hits shore. Our nation has an opportunity for greatness with the recent discoveries of energy combined with advances in all areas of technology and bio science. America is considered to be one of the safest places to invest in the entire world, and with one of the most stable governments. From my humble opinion on a very complicated subject, I think our National and most of our State Governments are a financial mess with problems ranging from ridiculously assumed high-rates of return on Pension obligations, to off-balance sheet debt. Can you imagine what will happen to America when our debt interest rate goes up? Paying the interest on the debt in our current rate environment equate to 8.6% of the US Federal Tax Revenue, or $223.5 billion. If rates go up and China and other lenders start getting 1.5% more on the $16.9 trillion debt = an added $25billion gets leaped on the pile making it harder to pay off. Plus we have a $1trillion yearly deficit. Statistics source 3rd party website www.usdebtclock.org. Many of our local states have an equally horrific balance sheet. As a financial advisor my greatest fear is not economic collapse, but rather the divide between the masses. I fear growing resentment and pressure on those that have succeeded and played by the rules which will translate into unfair taxation and restrictions.

So moving forward I believe opportunities will continue to present them relative to our current environment, and I am continuously looking on ways to identify and invest.

All the Best,

Ian Goldey

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