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"Water, Water Everywhere & Nor any Drop to Drink"

The global financial markets remind me of the thoughts someone floating in the ocean, fighting to survive, would have: Water is needed for survival, and I am surrounded by water, but none of it is drinkable without dire consequences.

So what has our government done recently to help Americans quench their thirst? Primary tools have been injecting liquidity into the system, manipulating interest rates lower and supporting a weak US dollar.

All of this liquidity and lower rates should be the "Water, Water Everywhere," but the banks are not loaning the money, which sparks the second part of the phrase, "Nor a drop to Drink." It is an amazing time to borrow and invest, which would be the right formula for stimulating private enterprise investment, but the only entity hiring in volume is the US government. This should be an incredible time for banks to post profits with low rates, but because of uncertainty surrounding legislation, they are afraid to deploy capital. Soldiers during World War II came up with the perfect acronym to describe our current economic and political climate in America: FUBAR. To keep this newsletter family friendly, I will let those who do not know the definition of FUBAR, look it up on their own or ask a friend.

James Carville, during the Clinton campaign, originated the phrase, "It's the economy stupid," when talking about strategies for winning the election. In the recent Republican debates held at the Reagan Library in neighboring Simi Valley, CA, Newt Gingrich succinctly illustrated the positive affects an unemployment rate of 5% would have on our nation's budget. We need to free up capital so people will get hired to do jobs!

Let us go back to the idea of being surrounded by water, but substitute water for value stocks. My portfolios are filled with companies that are cash flow positive and selling at low forward earnings multiples. None of this matters if people are panicking. Ben Graham, who is recognized as the father of value investing and was Warren Buffets' mentor, said, "In the short-run the stock market is a voting machine and in the long run it is a weighing machine." In my professional career, market pullbacks and volatility have occurred many times and to different extremes. Currently, one focus I go to during times like these is searching for deep value with hopefully an above-average market yield.

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Deep value should provide a floor on the stock and can also pay out dividends while we wait. Recent additions to our portfolios have been: GE yielding close to 4%, BAC preferred yielding over 8%, CTL yielding close to 9% and a few others. One name with no dividend, but one that I consider a great stock to own in this economy, is stock symbol UHAL. The parent company is called AMERCO, but most Americans know the familiar orange trucks for U-Haul. What you might not know is AMERCO is the second largest owner of storage facilities in America and they also have other businesses including insurance. UHAL is selling now for a forward P/E (price earnings) of only 6, while PSA (Public Storage) is selling for a forward of almost 31. Public Storage is selling for a large multiple because people in limbo from the current economy are providing great business, and the revenue is fairly consistent. As I look at the two businesses on a fundamental level, I like U-Haul better because of the truck moving component and their greater diversity. I add in the low valuation and U-Haul looks like a bargain compared to almost any stock. None of this analysis matters in the short run, however, if the market is not buying your stock. Markets like this test an individual's patience, and emphasize why Ben Graham's comments regarding time duration is so important to realize full potential.

Berkshire Hathaway recently announced that for the second time in their history, they will be buying back stock because they have a large amount of cash and feel their own stock is undervalued. As most of you know, I started buying Berkshire this year for the fundamentals and their awesome ability to generate free cash flow.

Let us return to jobs and unlocking the potential balance sheet of the banks. I hate relying on legislation as a catalyst, but unfortunately I think that is where the bottleneck exists. We have people willing to work, small and large companies looking to hire and expand, but uncertainty is absolutely killing our economic recovery.

In previous newsletters, I discussed housing as a fundamental keystone to economic recovery, and I still believe this to be true. Recently foreclosure activity has increased, which will hopefully lead to a clearing out of necessary dead assets on bank balance sheets. The foreclosure process has been so bogged down with paperwork that investors do not want to bid on these bank-owned properties. It takes the banks so long to make a decision that investors cannot wait forever. Now for people living in areas like California, where houses cost a little more than those in Kansas, the one year expiration of conforming loan limits has just reverted back to $625k (from recently $725k). What does this mean? It will take a bigger deposit for an individual to buy the million dollar home or be faced with higher rates. This reversion will surely impact home sales, so I do not expect we will see California real estate market recovery for at least another year or more.

By all measures we should have higher rates but we don't. Additionally, for the first time I can recall, the US government has publicly stated they will keep rates low for an extended period, until 2013. The US 5yr Treasury just fell under 2%, and similar low yields for the 10 yr (which is the basis for many loans, including homes) and 30yr. The additional kicker came with the panic of Europe and additional purchasing of US government debt. So, for all of our country's problems, we are still viewed by most of the world as the safest economy. Another economy that is fundamentally stronger is the Swiss economy, and thus has a stronger currency. The Swiss just experienced a major rally into their currency, which should be good, right? No, not really, and here is why. With the Swiss currency ultra-strong, foreigners cannot afford to buy their goods or stay in their country to vacation. So the effect of the strong Swiss currency is that vacation spots are empty and manufacturers have had to lay off workers. This is why economics is a difficult balancing act and extremes are unwanted. Say what you will about our current Federal Reserve Chairman, but Bernanke has an extremely difficult job, and he seems to be walking the tightrope as best as any human could.

Last month my family vacationed in the Mediterranean where we visited Greece and one of their beautiful islands. I mention this because of all of the talk regarding Greece and their impact on the global markets, and potential of being a tipping point, like the collapse of Lehman Brothers. Before I visited, I was of high conviction that Greece "would default or severely re-structure their debt." Now having been there, I am convinced of their demise. I saw many examples of dysfunction around their most popular monuments that it spoke volumes about their problems. How the other world economies deal with this debtor will be a tipping point or not. Why? Because if you let Greece off the hook, then other debtors will ask for something similar. This is called a moral hazard, just like walking away from a house payment with no recourse because its value is under water, even though you can afford to make the payments.

What is next? Unfortunately I think all eyes need to be on politics and less on economics or investing fundamentals. This is what I am paying close attention to, while along the way trying to find a bargain or two. The additional element is the flexibility to change quickly.

Sincerely,

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