

January 2, 2013

Greetings,

It is during times like this with all that is doing on that I tend to think back to the past and remember conversations that I have had with various people. I remember especially when a client who I have known since I was in high school asked me during the bear market that was caused by the tech. bubble if what was going on with the market at the time was scaring me. My response was that even though things didn't look good, I was not scared. I explained that there is a big difference between temporary (paper) losses and permanent losses of capital. When you invest in a private company and it goes out of business, you have a permanent loss of your investment. He then responded that I should let him know when I am scared because then he will be scared. During the financial crises, companies such as General Motors and Lehman Brothers went bankrupt as well as several other big name companies. Since GM was granted a lifeline by the government, a "new" GM was created so the shareholders of the "old" GM lost everything. I wasn't scared during the financial crises. It was an extremely unpleasant time to be an equity investor. I have watched the HBO movie "Too big to fail" numerous times. It is an outstanding movie about the financial crises and if you haven't seen it, then I suggest that you take a couple of hours and watch it via HBO on demand. Every time I see it on one of the HBO stations, I stay with it until the end. Each time I watch it, I feel like I am reliving a nightmare. Nightmares do end eventually. I wasn't scared at that time because I knew that the companies that I owned whose prices were decimated were operationally solid companies. Since I knew that the fundamentals were sound and that the nightmare would soon end, I saw the crises as an opportunity to make some serious money with the cash that I had available. My investments tripled from the market lows in March 2009 to the present. Keeping a cool head when others threw in the towel proved to be beneficial.

While I am not scared today, I am very concerned because of what is going on in Washington D.C. It is concerning because these politicians who are supposed to have been elected to run the country in a responsible way for the greater good are now capable of doing mass destruction to the economy. I can't remember watching the news (in addition to CNBC 8-9 hours a day, I have been watching CNN at night + FOX news now and then) so much as I have the last several weeks as the country just about went over this "fiscal cliff".

I literally got sick to my stomach as I saw these elected officials being interviewed daily on CNBC. All these people would do is constantly blaming the other side for things not getting done. No matter what, it was always the other political parties fault. As far as I am concerned, with two exceptions, each and every member in Congress, as well as the President should be ashamed of themselves. In any complex situation, you have to be willing to compromise. Whether it is a friendship, a marriage or a business

partnership, you can't always have your own way. Of course both sides claimed that they compromised and after several weeks of unnerving the citizens of this country, both sides did give a little bit but they didn't compromise enough. The two exceptions were Mitch McConnell (the Senate minority leader) and Joe Biden, the Vice President. While I have no love for Mitch McConnell (mostly because he famously said that his goal was to make sure that President Obama would be a one term President soon after the 2010 mid term election), in this situation I give him credit for reaching out to Joe Biden once negotiations broke down with Harry Reid just days before January 1. Joe Biden was a long time member of the Senate and has a 20 year history of working with Mitch McConnell. The two of them over a day and a half were able to come to an agreement, thus averting the fiscal cliff. The problem is that even though the country didn't go over the cliff (which would have surely resulted in a recession if we stayed over); they basically kicked the can down the road. This deal has virtually no spending cuts. The spending cuts (or lack of them) were postponed for two months so we will be going through this again in late February. There was a decent compromise on the tax issue.

If you are interested in details on the tax agreement, please email or call me. I will also provide my opinion on why it is a decent agreement. It is just too detailed to go into in this letter.

As long as the politicians don't destroy the economy and throw us back into a recession, I am very optimistic about the stock market for the near future. The market has shown to be remarkably resilient. The market did well last year despite the recession in Europe. The market shrugged off the slowdown in China and did well despite the fact that cash flowed into fixed income mutual funds and continued to ignore equity mutual funds. Corporate earnings in the third quarter were as bad as they have been since the recession, yet the market still held up. There were numerous opportunities for the market to crash and burn but it did not.

It is because the market has shown so much resilience that I am optimistic about the near future. Another reason is because many of the problems are in the past. While things in Europe are not good, it looks like the economy has hit bottom over there. If anything, the European stocks are doing well in anticipation of better times ahead. There were concerns that China was heading for a hard landing but that has not been the case. There are signs of improvement in the Chinese economy. The key is that the Real Estate market is beginning to come back. Real Estate took the economy down and it will lead it back. I also figure that if the market did well with all the cash flowing into bond mutual funds, can you imagine how much stronger market returns will be if cash actually flows from bond mutual funds into equity mutual funds this year? Some people think that this will be the year that there will finally be a shift in asset allocation from fixed income to equities. If the politicians can reframe from doing any further damage, then I will be in that camp. I won't even go into how interest rates are near zero and will be for the near future.

There was a front page story in a recent edition of the Wall Street Journal about how the Federal Reserve's goal of pushing mortgage rates down isn't being achieved. While interest rates are low by historical standards, the point of the article was that they aren't

as low as they could be. It was educational reading. I am very well aware that lending is way down. What I wasn't aware of is that the spread that the banks are charging between what they are lending at and what their borrowing cost is 25% higher from 2009 and more than double from 2006. If you want more details, I will gladly mail you a copy of the article. A cynical person could make the case that the banks are profiteering at the taxpayer's expense. Normally, I would not be in this camp since a goal of a business is to make as much profit as possible for its owners. However, these financial institutions (with a few exceptions) would be out of business without the help of the taxpayer funded bail out known as TARP. I won't even go into the fact that the banks were not innocent victims because they helped cause the financial crises. The banks response in the story is that they need to charge more to make up for "the risk premium". Since the banks lending standards have increased, thus making lending less risky, I did not understand the response in the article. I have a friend who works for a bank and he explained it so that I realized what I was missing. To paraphrase, basically, the banks need to have a larger profit margin because of all the extra fees (as a result of government legislation) that they incur now, because of the risk of litigation (mostly from the government) and because there is less liquidity in the markets for them to sell the mortgages that they originate. So, in a nutshell, they are passing along their costs to the consumer. I remember when the people in Washington (yes, back to them again) were debating the 2000 page Dodd Frank financial services bill, one of the many critiques were that if you add costs to the banks, they will not absorb them. They will simply be passed along to the consumer and this was 100% correct. The great defender of the consumer is Elizabeth Warren. She is now a newly elected Senator from Massachusetts. Ms. Warren was instrumental in organizing the Consumer Protection Agency. I recently read that she will be on the Senate Finance committee. It will be interesting to see if this Washington outsider will be able to accomplish anything to benefit the consumer now that she is a Senator.

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