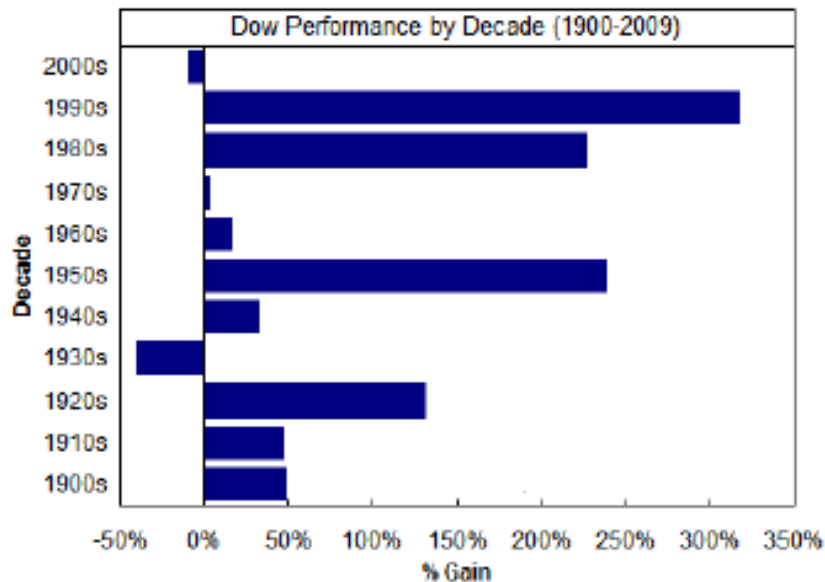


A Special Report
January 22nd, 2010
Bubble, Bubble, Toil and Trouble

For the past few weeks, I've probably read a dozen or more articles lamenting the dearth of returns in the equity markets over the decade just ended. "The Lost Decade" of the 2000's was in fact, the worst decade for domestic equities' returns in the past seven, a decade that differed dramatically from the two prior.



Source: chartoftheday.com

The fact that we recorded a net loss in stocks' values *for an entire decade* is even more remarkable when one considers that our economy (as measured by our country's Gross Domestic Production) actually *grew in size* by more than half (52.6%) in nominal dollar terms (\$9.3 Trillion to \$14.2 Trillion), and by almost a quarter (23.5%) in "real" (inflation-adjusted) terms over the same period. (Source: Department of Commerce's Bureau of Economic Analysis)

Perhaps just as accurate a term as any in describing the period might be "The Bubble Decade", as we were plagued by a series of "bubbles" in various markets, some of which spawned *mini-bubbles* of their own. The primary culprits were:

The Tech Bubble

Perhaps the granddaddy of modern-day bubbles, the Tech Bubble (a.k.a. “the Dot-Com Bubble”) was really born in the decade prior. Investors bid up internet and technology stocks over a five year period (1995-9) to prices which bore absolutely no resemblance to their tangible assets, profits, or any other traditional measure of fundamental valuation. Initial Public Offerings in the technology industries were vastly oversubscribed during this period, despite the fact that many of them came to market with no customers, no real prospects for profits in the foreseeable future, and little more than a business plan behind them. The feeding frenzy around these offerings was so rabid I once had a client order me to “buy *anything* offered that ended in ‘dot-com’”. (You’ll be happy to hear that we were able to convince him that wasn’t a sound buy discipline.)

The tech-heavy NASDAQ Composite Index, which began the bubble period at a composite value of 749 (01/01/1995), blew up to an intra-day high of 5,133 on October 10th, 2000, when it finally began its deflation. That’s an amazing 44% compound annualized rate of growth for more than five years!

When investors finally woke to the realities of the grossly exaggerated valuations, the bubble finally burst, and over the thirty months that followed its peak, the NASDAQ Composite Index fell an incredible (-78%), to a reading of 1110 on 10/08/2002. (The Index stands at 2278 at this writing, a double from its bottom seven-plus years ago, but still less than half its reading from a decade ago.)

The Housing Bubble

As the American lexicon has developed over the years, the phrase, “The American Dream” has come to mean home ownership. Owning the home with the white picket fence around it is a cliché, but it is forever linked to participation in said dream in most American’s eyes. Over the decade just ended, that dream became reality for an increasing percentage of Americans. Unfortunately (and ironically), to the detriment of many, we’ve come to see that the “dream” has for many, devolved into a nightmare of unforeseen and unimagined proportions.

The Federal Government has always been obsessed with its desire to increase home ownership in America. Prior to the Great Depression, fewer than half of all Americans owned their dwellings. In 1938, in response to these unacceptably low ownership percentages, Congress created the Federal National Mortgage Association (Fannie Mae), with a mandate for creating a liquid secondary market for mortgages. It worked well initially, and in 1968, The Charter Act converted Fannie Mae into a privately owned, but Government Sponsored Enterprise (GSE). Mortgages were “securitized” for the first time in that Act, and with the government’s backing, a ready market for purchasing these loans grew even larger. The Act also established a regulatory structure through the Department of Housing and Urban Development, or HUD, through which Congress could oversee its work and assure its adherence to its public purpose. The creation of Freddie Mac, another privately-owned GSE whose purpose is to provide additional access to mortgage dollars, followed closely, and today, Fannie Mae and Freddie Mac

hold (or back) almost \$1.75 Trillion in government backed mortgages on their balance sheets.

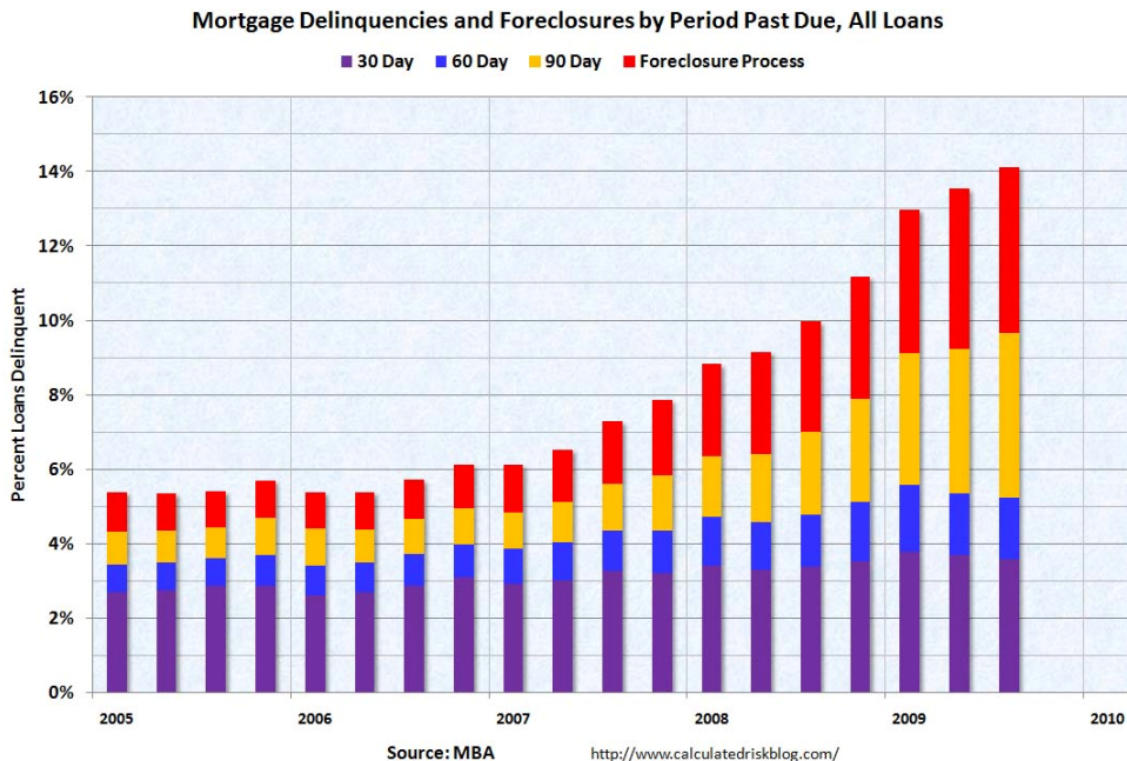
Initially, the purpose and structure of these entities was clear, and clearly beneficial to their purposes to provide liquidity (i.e. adequate mortgage funding) at a reasonable cost to prospective home buyers. But as is seemingly the case with most anything that government sees as “working”, Congress and the Bush Administration decided to “improve” on it, and in their wisdom, effectively decided that *everyone*, regardless of their creditworthiness or ability to put a down payment toward it, should be able to buy a home. Over the decade just ended, minimum credit requirements and loan-to-value ratios were virtually eliminated. “Low-doc”, and even “No-doc” (i.e. “stated income”) loans were authorized, and prospective homeowners could simply say they had a certain income, and, with a stroke of a pen, qualify for a loan of the entire purchase amount.

As one might expect, homeownership boomed over the decade, and by 2006, homeownership in the US peaked at 69%. It has fallen a bit the past couple of years, but according to the Bureau of the Census, it remains at 67.6% as of the end of the third quarter of 2009.

The increase in the number of buyers led to a corresponding boom in home prices, as an increase in demand typically does. According to the National Association of Realtors, the median home price in the US began the decade at \$137,600, then “bubbled” to \$221,900 by 2006 (up 61% in six years), before bursting, and falling back to \$171,900 at the end of 2009. In “real” (inflation-adjusted) terms, median home prices actually fell in America by 3% for the decade.

As we now see all too clearly, many of the intended beneficiaries of these relaxed underwriting requirements, believing home prices could only go up, purchased homes using adjustable-rate mortgages (backed by Fannie and Freddie) putting little or no money down, at, or near the peak of the housing bubble. They squeezed as much home into the payments they could qualify for, often buying much, much more home than they could reasonably expect to afford, had they been using traditional, fixed-rate mortgages. Millions others used their existing homes as “piggy banks”, taking every drop of equity from their homes using Home Equity Credit Lines (HECL’s) that banks and lenders added (at no cost) to virtually every first mortgage they issued. HECL’s were typically issued with the convenience of a checkbook, and boy, did American homeowners use them! To their dismay, American home owners soon discovered that their home prices could indeed fall, and millions upon millions of them found themselves with “negative” home equity by the end of last year, and facing payment “re-sets” to monthly amounts they simply couldn’t afford. In 2005, at the peak of the frenzy, just 850,000 homes, or less than 1% of single-family, owner-occupied dwellings were foreclosed upon in the US. That rose by an amazing 42% the following year, and the numbers have climbed steadily since. This year, despite the current Administration’s efforts to help borrowers refinance loans and stabilize home prices, there may be as many as 3.5 million housing foreclosures.

It is estimated that as many as one in four homes in the US is “under water” today, worth less than what is owed on it. While home prices do appear to have stabilized in recent months, with employment at very weak levels, Americans’ ability to continue making their mortgage payments while they wait for home prices to re-inflate has been severely compromised. Many lenders are playing the “extend and pretend” game, avoiding the initiation of foreclosure procedures, hoping that borrowers will do whatever it takes to keep their homes, and this is why the number of projected foreclosures this year isn’t much, much higher. According to industry statistics kept by the Mortgage Banker’s Association, approximately 14% of *all* residential mortgages in America are delinquent 30 – 90 days, or are in the foreclosure process. Unfortunately, that is an all-time record.



Credit Bubble

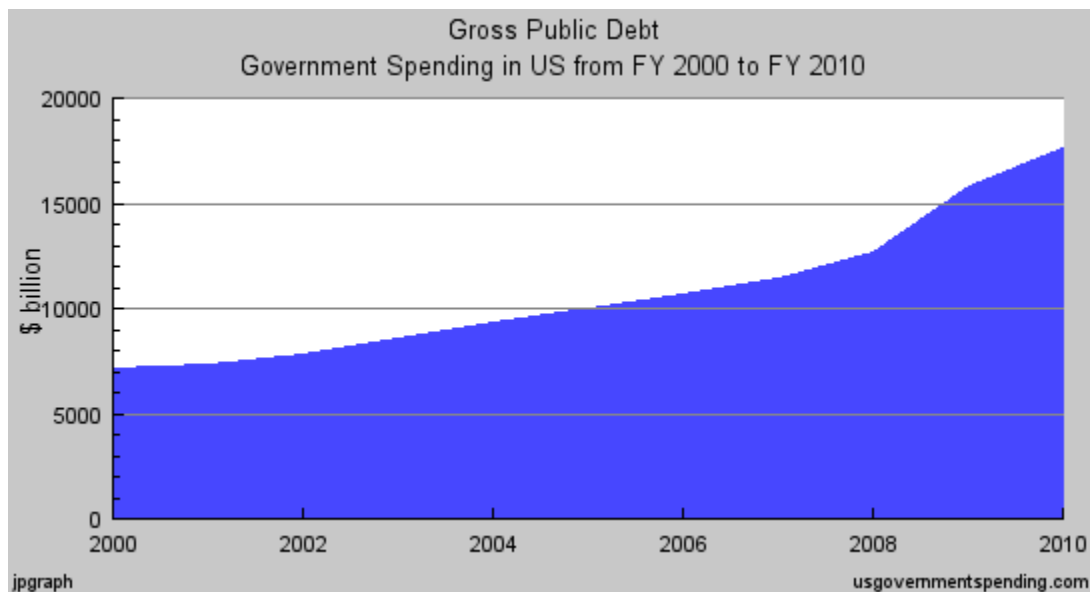
American consumers, representing less than 5% of the world’s population, but 25% of its consumption of goods and services, have always shown a prodigious appetite for debt. The aforementioned home equity “drain” wasn’t the only way they were adding to their liabilities. According to CreditCards.com, in 2003, Americans holding Visa, MasterCard, American Express, or Discover Cards, executed 14.7 billion credit card transactions, purchasing \$1.274 Trillion (with a “t”) worth of goods or services. Just five short years later, in 2008 (the last full year for which they have data), those credit cards were used in 21 billion transactions (up 42%), purchasing \$1.969 Trillion in goods and services (up 54%). Those four issuers alone now have 636.1 million cards in circulation nationally,

along with another 482 million debit cards. Total credit card debt outstanding at the end of 2008 had “bubbled” to \$972.73 Billion, and the youngest consumers amongst us are an increasing percentage of the total, a disturbing trend. The average “young adult household” carries an average \$10,679 in credit card balances, and that same household spends 24% of its earned income on debt service today.

The consumer is up to his/her eyeballs in debt, and for the most part, that debt was incurred in the fairly recent past.

Government Debt Bubble

American consumers are awash in debt, but while they were dramatically building the liabilities side of their individual ledgers, the federal and state governments were showing them how it’s *really* done.



When the previous decade began, combined Federal, State, and Local Governments (Gross) Debt totaled \$7.126 Trillion, or 73% of our Gross Domestic Production at the time. Said another way, there was \$25,323 of allocable debt for every one of the 281.4 million men, women and children counted in the 2000 US census. Ten short years later, as this chart details, total Government Debt has “bubbled” to \$17.653 Trillion, an incredible 147% increase in the total debt on our governments’ balance sheets in ten short years. The total debt now represents a whopping 120% of our GDP (versus 73%), and per capita allocable debt has “bubbled” to an estimated \$55,952 for each and every one of the 315.5 million American citizens living today.

According to a report issued by the Congressional Budget Office (CBO) last June, the interest carrying cost to the Federal Government in service of its \$12.016 Trillion of Treasury-issued debt (\$7.703 trillion of which is publicly-held) was \$381 billion in fiscal year 2009. Using fairly conservative assumptions for future interest rate carrying costs,

the CBO projects that cost to rise to \$930 Billion by fiscal year 2019, when total federal government debt is projected to be \$18.810 Trillion (with \$11.753 Trillion being held by the public). As a percentage of the \$4.247 Trillion in revenue inflows the CBO projects the Treasury to receive that year, debt service costs alone will reach 22% of its budget, a percentage not far from that of the aforementioned debt-riddled young households. (Maybe the government needs credit counseling too?)

The trend toward a more “socialistic” tax and spending policy in the Federal Government is even more problematic. While recent problems inherent in unfettered (and inappropriately-regulated) capitalism have shocked and angered many (Bernie Madoff, Alan Stanford, and Collateralized Debt Obligations come quickly to mind), the record on bigger government is clear, and in my opinion, even less effective. Entitlements, once given, are never removed, and they are rarely properly funded, but grow larger by the year. Government spending is rising at rates unseen since World War II. The Government’s recent incursion into the auto, banking, housing, and capital markets over the past year has been nothing short of breathtaking. They (apparently) arbitrarily decide which entities will survive and which will not. They select corporate management, and replace them as they deem necessary. The new taxes they propose on a weekly basis (literally) gives clear indication of their redistributionist intent. The dollar has declined substantially in value over the past year, and the actual printing of trillions of dollars by the Federal Reserve assures further declines in its value across the globe, which is, in and of itself, inflationary, even within an economy that’s stagnant. This is *not* a recipe for expansion in the buying power of US consumers, nor for attracting investors that will be needed to buy all the US Government issued debt the Treasury will be selling into the global capital markets over the next decade or more.

Outlook?

With all this as a backdrop, and with the impressive bounce equity prices have had from their March lows, the question I hear most often speculated upon in the financial media is, “*Having clearly suffered through a decade of sub-par returns, could this (bounce) be the signal of a new, secular bull market?*”

We think not, despite the maddening length of the current secular bear market. When one looks at “conditions on the ground”, and compares them to 1982, the last time the equity markets transitioned *from* secular bear *to* secular bull, the outlook for further, sustained advances is, to say the least, discouraging. My good friend, Mike Malone of MJM401(k), shared the following chart with me:

Market Conditions Today vs. August, 1982

United States	1982	2009
Fed funds rate	18% (can only go down)	0% (can only go up)
10-year bond yield	15% & falling	3.8% & rising
Monetary base	\$170 billion & rising	\$2.2 trillion & stable to falling
Budget deficit-to-GDP ratio	-3% & moving towards surplus	-10% & steady or falling
Household debt-to-disposable income ratio	62% & rising	123% & falling
Inflation rate	10% & falling	0% & rising
Savings rate	10% & falling	4% & rising
Unemployment rate	10.8% & falling	10% & rising
Misery index	At 16 & falling	At 12 & rising
Labor force participation rate	64% & rising	65% & falling
Tax rates (highest marginal)	69% & falling	35% & rising
Union share of the job market	20% & falling	12% & rising
Global trade barriers	High & falling	Low & rising
Profit margins (room for expansion)	6.0%	10.0%
S&P 500 P/E ratio (1 yr trailing)	8.0x	20.0x
P/E ratio (10 yr normalized in real terms)	7.0x	23.0x
S&P 500 price-to-book ratio	1.0x	2.2x
S&P 500 dividend yield	6.0%	2.0%
Investor sentiment	10% bullish	88% bullish
Baby boomer population	Median age 25, peak spending & investing yrs (capital gains)	Median age 52, retirement focus ahead (capital preservation)

Source: Haver Analytics, Gluskin Sheff

Despite the exponential increase in the speed of global market information flow that has occurred over the past decade, there has developed a “perfect storm” of sorts. A storm of speculative bubble after speculative bubble, one building to another, and a storm that has left the US consumer’s balance sheet, the ultimate supporter of all these costs, weakened to unhealthy, some would even suggest, bankrupt levels.

Try as we might, it is hard to imagine the scenario in which consumers, who are (1), facing low-to-negative home equity today, (2), holding retirement accounts ravaged (still) by the bear market, (3), carrying 50% more consumer debt today than they did a decade earlier, and (4), are projected to be responsible for more than twice the government debt a decade hence, could reasonably be expected to sustain the spending and investing levels *necessary* to create sufficient demand for equities that would be the necessary precursor to a new, secular bull run.

Don't get me wrong. As depressing as all of these data can be, my faith in the capital markets' ability to overcome even these substantial headwinds remains intact. It's the *timing* and *sustainability* of the current recovery I question. I also observe that there is a long list of reasons this secular market trend might last more than a decade, and, unfortunately, they historically *have*. The confluence of these headwinds points to this market trend not being an exception to the historical record.

In summary, this up and down, up and down, movement in the equity markets is, in our opinion, likely to continue for the foreseeable future, perhaps for another five to ten more years. In our opinion, such a "bubblicious" environment clearly dictates an active, tactical, and (primarily) defensive approach to investing in the capital markets. As this is written, our model portfolios have less than 30% (aggregate) exposure to the equity (stock) markets, and a similar allocation toward debt (bonds), all of it managed by professionals with sell disciplines intended to protect us if, or more accurately, *when*, the declines manifest.

As always, please feel free to call me with questions and comments.

- JRP

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What's "Right" With America

Profile: Jack and Jeanne Sander

Jack and Jeanne Sander are likely the nicest people you'll ever want to meet. I'm blessed to work for a lot of wonderful people in my occupation, but I can say without fear of contradiction that they are a couple of the kindest, most genuine people I know, professionally or otherwise, and readers of this essay who know them would heartily agree, I'm sure.

Both Jack and Jeanne were raised by loving, middle class families, each with one brother. Jack was born and raised in Cincinnati, his father an employee of Cincinnati Bell who started his career climbing telephone poles, and who worked his way into a supervisory role, while his Mom was busy raising two boys at home, and eventually worked part-time in his high school cafeteria. Jeanne's folks, Harold and Alma Weiss (also lovely people and clients of our firm) made their home in Cincinnati as well, but Jeanne was born in Miami, while her Dad was temporarily stationed in the military before being shipped out to fight during World War II. It was in grade school that she and Jack met, and in high school they became sweethearts, eventually marrying in 1965, when Jack was 24, and Jeanne was, well, several years younger.

Jack attended the University of Cincinnati, graduating a year before they married with a Bachelor of Fine Arts in Business, with an emphasis in Radio and Television. Jeanne pursued her artistic abilities at the Central Academy of Commercial Art in Cincinnati. They quickly got a family of their own going, with the first of their three daughters (Jennifer) coming along in 1967. Two more daughters (there's a "gender theme" going on here that will become apparent later), Jodi and Julie, arrived two, and four years later, respectively.

Jack jumped into the broadcasting industry with both feet, his first job right out of college in 1965 as a Sales Service Director for a Columbus, Ohio NBC affiliate, WLWC-TV. He was hired away soon thereafter by Cosmos Broadcasting Corporation, owner of a Toledo, Ohio CBS affiliate, WTOL – TV, where he became an Account Executive. He held various sales management positions there, and he was eventually named Assistant General Manager of the station in 1976. Recognizing Jack's sales and managerial abilities, Cosmo transferred him to their (larger market) New Orleans station, an NBC affiliate called WDSU – TV in 1978, as Assistant General Manager and Station Manager. Two years later, WTOL – TV came calling again, and brought him back to Toledo, this time as the station's General Manager. Two months after his arrival in 1980, at the ripe old age of 38, the title of Executive Vice President was added.

Two years later in 1982, this rising star was offered the job of President and General Manager of Phoenix's CBS affiliate, KTSP – TV, where he served for three years. In 1985, Taft Broadcasting's Television Division lured him back to his home town of Cincinnati with an offer to run *all twelve* of their television stations, a job he held through 1988, through Taft's eventual sale of their television group.

Next stop was Atlanta, with the opportunity to run Gillett Communication's WAGA – TV as President and General Manager, a major market station that was initially a CBS affiliate. During Jack's tenure, billionaire investor Ronald Perelman (Revlon, Marvel Entertainment, among others) purchased WAGA – TV, a six other CBS – affiliated stations through his New World Communications conglomerate, and transitioned them to Fox affiliates. Jack remained at the station's helm for ten years, until 1997.

It was at that point in time that A.H. Belo Corporation (now Belo Corporation, NYSE Ticker Symbol: BLC) of Dallas came calling, as they were morphing from a newspaper (print media) business into a media conglomerate that would come to hold 20 television stations and several cable systems as well. Jack was named Executive Vice President of Television Group, promoted a year later to President of the Group. In 2001, his title became President, Media Operations, responsible for all media operations, a position he held until 2005, when he was promoted to Vice Chairman of the Belo Corporation. We met, and began working with the Sanders in 2005, a year before he "retired" at the age of 65, in 2006.

As for community service, over the years he's served on the Boards of the Phoenix Chamber of Commerce, the Salvation Army, the Phoenix Metropolitan Sports Foundation, the United Way of Metropolitan Atlanta, and the Red Cross, just to name a very few among many, many other community organizations.

I use the word "retired" loosely, as Jack's as busy today as he was when he was working. Always involved in civic affairs, industry groups and charitable causes, Jack has served on the boards of Broadcast Music Inc. (BMI) since 2004, and is its current Chairman. He's also on the Executive Committee of The National Association of Broadcasters (NAB), the broadcast industry's lobbying arm, and was its Joint-Chair from 2006 – 2008. He served as Chairman of the NBC Affiliate Board of Directors, and he was also Chairman of the Television Bureau of Advertisers from 1990 – 1992.

His long career and estimable achievements in the broadcast industry were honored recently with his induction into the 2009 Class of the Broadcasting & Cable Hall of Fame in New York, alongside a "Who's Who" of other broadcast executives. While NBC's Brian Williams introduced him, and his peers honored him for a lifetime of industry achievement, I know that for Jack, the best part of the event was Jeanne and their three daughters were in attendance at the Waldorf Astoria to share in his moment. For Jack, this was a *family* achievement.

Jack's experience in the media industry is truly unsurpassed, as his peers have now formally acknowledged, and his passion for broadcasting and for media issues remains bright today. We love to get him talking about television, its programming, media personalities, and show business in general. Listening to his informed take on what is going on within the ever-present broadcast network battles is like getting a tutorial in the "business" side of television, as well as an insiders look at the behind-the-scenes decision-making and politics that exist in every industry, but none more so than show business. Jack is the consummate manager, a competitive businessman who says that when he was managing television stations, he "*loved the fact that he got a grade every day*" in his station's ratings, and that he could have a direct impact on so many people's lives through their broadcasts. Today, Jack believes that the industry faces increasing challenges from online media, especially in the area of local news and communities issues, which online media sources tend to under-report.

Despite Jack's Hall of Fame career, whenever I think of Jack and Jeanne Sander, Jack's career and their financial successes are *not* what come first to mind. The Sanders are not simply defined in just those terms. In fact, I doubt the Sanders think of their successes in financial terms at all. They are first, and foremost, *family people*. Jeanne's Mom and Dad, the Weiss', are sweet people, and the Sanders spend much of their time with them, as they live in the Valley as well. But in addition to their three daughters, Jack and Jeanne have been blessed with seven wonderful grandchildren (all girls!!!), Natalie (13), Lindsey (11), Cassie (7), Sarah (7), Allie (5), Molly (22 months), and Emily (14 months), names and ages that Jack was easily able to rattle off, even though he hesitated when I asked him how many years he'd been married. (Don't worry Jeanne. He figured it out!) They split their time when Jack isn't travelling between their beautiful home in Troon, Scottsdale, and their second home in Flagstaff's Forest Highlands. The grandchildren are often in tow. We have pictures of all of them on our office refrigerator, as their proud grandmother sees to it that we get the most updated pictures of these beautiful girls. (We often tease Jack that it is a wonderful thing that these girls favor their grandmother, and wonder how, with a *wife*, three *daughters*, and seven *granddaughters*, Jack ever has a say in, ... well...anything?!) The truth is that Jack may not have much to say about how things are run around the Sander house, but he is a well-loved King, adored by all those girls, and secretly, I don't think he'd have it any other way.

The Sanders are hard-working people, born to Middle America, and they have achieved financial and professional success that few ever do. (How many people get inducted into their industry's Hall of Fame?) But as I stated at the beginning of this essay, the Sanders are, quite simply, the nicest people you'd ever hope to meet. They define wealth in family terms, and by those terms, they are very, very wealthy indeed.