Capital Drain

Rick's investment opinion newsletter November, 2006 v.2 no.9

Hi Readers,

It's been a pleasant autumn so far, fairly colorful by California standards (we do have a few deciduous trees) with a little rain and this morning our first frost on the dock. Snow is starting to accumulate in the Sierra ski slopes.

I've been plugging away at the mutual fund project. The bad news is I'm a little behind schedule, but the good news is that I've learned a lot from some of the digressions which I didn't anticipate needed to go into the schedule.

Also, I took a few days off before the election to make phone calls to get out the vote. This was a project organized by MoveOn.com; the premise was that since California seats were safe, California volunteers could call other States. I must say, when the polls all closed and I finished my last call and turned on the radio, it was REALLY THRILLING to hear the names-- as likely winners-- of many of the candidates in whose districts I'd made calls.

It's the same as the paradox of voting: I made a negligibly small contribution, but because a lot of other people made the same miniscule contributions, too, we won. Cool.

OK, back to business. In my opinion:

Executive Summary:

- **It's that time again! Let's check on our credit reports together. This time, we'll go to Experian. It's quick and easy.**
- **Housing: falling; when will it stop?**
- **Gold up, Dollar down.**
- **US Stocks: a last hurrah?**

As before, I think everyone is best off with a **broad diversification** that includes at least **3/4 overseas** assets (easily purchased via US mutual funds), reflecting the distribution of world economic activity.

This is a good time for investors to be conservative, to be in the best of securities: stick to value, to safety, to short maturities (for debt), and call me to chat if you're concerned about anything you're holding.

Above all, avoid the investments that are at all-time extreme valuations: junk bonds, developing-country bonds, and headline-grabbing stocks with high P/E ratios.

The Details:

What the pundits said:

First it could never fall,
then Well, OK, it *could* but it won't,
then Maybe it will, but it *isn't*,
then OK, it is, but not much,
then OK, that's a significant fall, but "*Look! It's ending!*"
then...

I recommend that you ignore the usual mob of pundits for a while. The housing market is definitely falling. Despite an occasional little bounce in one or another market metric, it's probably got some distance yet to fall; most of the news is still bad.

Home sales volume has dropped precipitously. The number of houses on the market represents many months' worth of sales at the present rate. New-home developers are slashing prices to move out the inventory as current projects are finished, and not starting new projects. Cancellation rates, that is, former prospective buyers sacrificing their down payments to back out of purchase contracts, rose to 42 per cent across the industry in the third quarter.[1] Homeowners and especially non-occupant house investors are, many of them, choosing to lower their prices to get their sale done NOW, rather than waiting for the market to come back up to their former targets.

Most analysts are predicting little further decrease in house prices, but Yale professor Robert Shiller's analysis shows that housing price declines typically run 20% from the high, and Forbes columnist and bond analyst A. Gary Shilling is adamantly predicting a drop of 25-35%. You may take comfort that his is the most pessimistic prediction to date; it would be more comforting except that he's had a long career of being quite good with his counter-consensus predictions.

I doubt if any of you are going to rush out and sell a house on this news, nor would I recommend that anyone should, but still the housing market is important for investors in all markets. Building activity and building materials production were a big part of GDP these past ten years. Further, the past half-decade, as prices have rocketed upward, has seen many householders refinancing and taking cash (their equity) out and spending it. Between building and equity-financed spending, housing has been providing a big boost to the overall economy. Now it's not.

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[1] Eoin Callan and Doug Cameron, "Reduction in supply of new US homes brings the economy to tipping point," FT.com, 27 Nov. 2006 02:00, Financial Times Limited, 28 Nov. 2006 10:50 PST <http://www.ft.com/cms/s/12937ae6-7dbc-11db-9fa2-0000779e2340.html>.

The end of that economic stimulus is one ingredient in the great guessing game in the financial markets. The bond market seems to be guessing that a recession is imminent, will be more than just a passing squall, and will induce the Fed to lower short-term rates significantly. The stock market, on the other hand, has been hitting new highs, seeming to be guessing that the recent good earnings, due to good recent GDP growth, are going to continue for a while. Who's right?

A slightly different way to view that question is to look at how investors are compensated for taking risks. Basically, they're not; the additional return from risky investments is at a historic low. Many commentators say that since the market has little risk premium, i.e., little additional reward for taking risks, that therefore there aren't any risks.

I recommend an opposite conclusion: you're not being paid to take risks, so don't take them. This would be an excellent time to take your profits from stocks, worldwide but especially U.S. stocks, and put the money into something safer like U.S. Treasuries or (my choice) top-quality short-term debt overseas.

You're used to this topic, so I'll make it quick: the dollar is falling against almost all world currencies, including the stateless currency, gold. That trend is likely to continue for quite a while, or quite a big shift if the shift comes quickly. Putting a large portion of your money in international assets is very likely to get the benefit of a considerable average tailwind from the dollar's general depreciation.

If I may, a brief non-investment topic: have you ever wanted to be able to create .pdf files, the files that Adobe Acrobat reads, but haven't wanted to pay the whopping fee for Acrobat? Help has arrived. There's a free program called PrimoPDF that lets you "print" from any application to a .pdf file. That is, when you go to print a file, you can select PrimoPDF as your printer and it will create a .pdf file and ask you where on your disk to put it. This makes it easier for you to keep an immutable record of the state of file. If you wish, you can then use Acrobat (actually the free reader AcroRead) to sent the file to your real paper printer. You can download it from http://www.primopdf.com/

Now for some personal-finance housekeeping. Let's visit Experian:

- Open your favorite browser and go to https://www.annualCreditReport.com
- select your State and click "Request Report"

- Fill in the form with your personal information.
  - Click the little box that says "show only last 4 of Social Security Number in report"
  - Enter the security code (this prevents automated logins)
  - Press "Continue"

- Click the little box next to experian
  - Click "Next"

- Click "Next" again

- Enter the last 4 digits of your SSN
  - Click "Submit>>"

- Answer the security questions
  - Click "Submit>>"

- You should see the Report Summary page and instructions to make a note of your report number.
  - Make a note of your report number.
  - Notice where it says the number of potentially negative items, number of accounts in good standing, etc. Do the totals seem right?
  - Click the little link that says "Print your report". (It's on the same line as your name)

- This pops open a new page (or tab) with your actual report.
  - Read through it
  - Click "Print Report" (If you're trying PrimoPDF, this is when you select that as the printer in the Print dialog box)

- Assuming you haven't had any problems with these steps, you're done.

- Click "Close window" to close the print page/tab.
  - Click "Return to AnnualCreditReport.com" at the very top of the page. This logs you out from Experian.
  - Click "OK"
  - If you then get a message that your session has timed out, ignore it. You're done.
  - Close the browser window.

Congratulations, you're now one of the 1% most fiscally responsible people in the whole world. Reward yourself.

As I mentioned, each of us is allowed one free report per year per credit agency, of which there are three. That works out to allow you one report every four months. Those of you who are careful counters will have noticed that it's only been three months since we got reports from Equifax. That's because I may not write a December newsletter, and besides we'll all be too busy with holiday travel and festivities to want to mess with credit reports.

We're about to enter the silly season, when end-of-year considerations cause a lot of short-term unpredictable disruption in the markets. Some investors will suddenly be eager to take profits, others to dump losers, still others to jump on January's New New Big Trend. For the moment, I recommend that you just ride it out, and I doubt that I'll have anything very useful to say for month or two.

It's time for me to proofread this and send it.

If you have any questions, please write or phone. If you want to read more, I've got a web site with old editions of this letter and some links to other interesting sites.

Please feel free to forward this to any friends who may be interested.

Take care,

Rick

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"Our doubts are traitors,
And make us lose the good that we oft might win,
By fearing to attempt."
--W. Shakespeare
