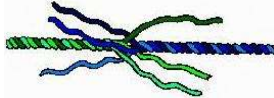
Capital Drain

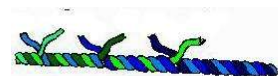
Rick's investment opinion newsletter March, 2007 v.3 no.3

Hi Readers,

The big news here is that I've resolved the naming issue.
The mutual fund company is called



Longsplice Investments

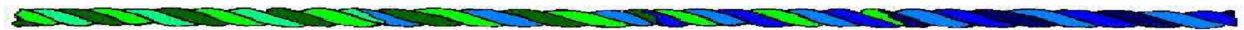


You can read about the progress in the blog, www.Ricks-Cafe.net/mf_startup_blog , or go see the new website, www.LongspliceInvestments.com .

The MF's name is the main marketing public face of the company.

A mutual fund "company" is actually a collection of companies. Separate and "hired by" Longsplice will be the advisory company: **Rick Drain & Associates**, or something like that, TBD.

This newsletter will remain my personal opinion forum, and will keep the name **Capital Drain** even as it becomes a property of RD&A.



OK, let's go. In my opinion:

Executive Summary:

Do yourself a favor, the preamble: Firefox.
Do yourself a favor, the big prize: AdBlock Plus.

Don't bet on favors from the Federal Reserve.
"A fine mess you've gotten us in this time..."

Behavioral Finance: Anchoring, part II.

> As I've written 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 and Exchange Traded Funds (ETFs)), 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:

I tend to be pretty conservative, reactionary even, about adopting new software. If the old program does what I want, I'll keep it, and I'm not much interested in the new-improved-totally-hip-latest-thing. Eventually, though, a new product can be good enough to get me to upgrade/switch.

The latest such experience was with the 'alternative' web browser Mozilla Firefox. Compared to Windows Internet Explorer (IE), it is faster, simpler, more secure, less buggy, and even IMHO prettier. And it's free.

You can download a copy at http://www.mozilla.com/en-US/ . When you install it, you can keep all your accumulated bookmarks by saying 'yes' to one of the prompts.

Just having a totally superior browser is nice, but the reason I suggest making the switch is even bigger: there's a great program that lets you ELIMINATE ADS from your browsing. It's like going to heaven. It works wonderfully. It's free. But it doesn't run on IE.

Assuming you've switched to Firefox, you can download Adblock Plus at http://adblockplus.org/en/installation . It couldn't be simpler, and it is such a relief to not see those dumb ads anymore. I highly recommend that you do yourself a favor and upgrade.

If only the current investment environment were so simple.

Don't bet on favors from the Federal Reserve. Many commentators are saying that the Fed is going to cut short-term rates soon because of this or that thing going wrong in the economy. Wishful thinking. The Fed is saying no such thing. They're focused on inflation, which is still much higher than they want it to be.

The commentators' reasoning is that lower rates will lower the mortgage rate, rescuing the housing boom, and increase investment and consumption, rescuing the whole economy. Point by point:

- The Fed's main concern is the stability of the currency. That's their job. They're also supposed to balance that with encouraging an economy without excessive unemployment. Supporting housing or stock prices is not their job.
- Unemployment as generally measured is acceptably low, but inflation as generally measured is too high. Fed officials have said they're as likely to raise rates to fight inflation as to lower them. No one wants to hear the 'raise' part.

- Anyway, the Fed affects short-term rates, but mortgages are driven by long-term rates. Lowering the Fed rate is unlikely to help the housing slump.
- It's even possible that a lower Fed rate in the face of excessive inflation would scare the bond market. Inflation is slow death for bonds. If the Fed tries a 'stimulative' rate decrease before bond investors are comfy with inflation decreases, the long interest rates would go UP, taking mortgage rates with them.
- Foreign exchange rates are not part of the Fed's job, but they're not inconsequential to inflation. If the Fed cut rates, dollar investments would be less attractive, and the dollar could fall. If the dollar falls, the prices of our many imports will rise, at lease somewhat. Thus, a Fed cut could actually increase inflation.
- None of the above is news to the folks at the Fed. It's only the TV talking heads that seem confused.

"A fine mess you've gotten us into this time..."

As far back as my very first newsletter (Dec. 2004) I warned readers to be very careful to understand the terms of their adjustable-rate mortgage (ARM) contracts. The previous February, then-Fed Chairman Greenspan had broadly endorsed ARMs. (But not quite recommended them, although many people took it that way.)

Well, his endorsement has not just bombed, but Blowed Up Real Good.

We're hearing first from the very weakest borrowers, the Sub-primes and Alt-As. Many of those borrowers were unable to keep up their mortgage payments even at the low teaser rates. We have yet to hear from the many prime and near-prime borrowers who were careless about their ARM contracts and are about to get nasty surprises as their mortgage payments jump up. This wave has not yet peaked.

No one meant to get into this mess, of course. If house prices had simply kept going up, then everyone could have conveniently re-financed. Also back in the first letter, I warned that real estate gains had been far beyond historical norms, and that people were over-eager to believe the gains would continue. People got over-confident and took excessive risks.

Now, we have a record high (post-Great Depression) housing foreclosure rate.

You can check last November's newsletter for a long discussion on how the housing plunge and disintegrating housing industry are bad for the economy overall.

We may already be in a recession. It certainly looks as if we will be in one, sooner than people expected. The Leading Indicators are STILL going down, the Treasury yield curve is STILL inverted, and various concurrent indicators are looking much worse than expected. It's not promising. The stock market is getting very nervous and jumpy, as more traders see tougher corporate profits ahead.

So now, back to the top. Is it "raise the Fed Rate to nip off inflation," or "cut the Fed Rate to nip off recession?" If it's both inflation and recession, that's stagflation. (See the June/July 2006 edition for details.) That's the least fun of all.

Don't expect any favors.

What to do about it?

I still think the dollar will continue its fall. It's been accelerating lately.

US stocks could be vulnerable to a recession, but US bonds could be vulnerable to inflation. Yuck.

Overseas stock markets could be vulnerable to a US recession, too. The blue-chip stocks of developed countries should hold up best; developing countries' shares are more likely to drop.

Overseas bond markets have been so-so lately from our perspective: helped by the falling dollar, but hurt by rising overseas interest rates. If the US were to have a recession which decreased growth, and level or falling inflation elsewhere, then **overseas bonds** could be the big winner. Again, big stable developed countries and their best companies are the safest bonds.

Oh, and if the dollar falls a lot, gold will likely go up too, but think of that as possibly a bit of spice for your portfolio, not the entrée.

Based on that, I'd be tempted to some take profits in US stocks, and shift more money to mutual funds investing in good overseas stocks or bonds.

Important: current prices do not offer much reward for holding risky stocks or bonds (i.e., high-PE stocks, high-yield bonds). You're not being rewarded for taking the risks, so DON'T TAKE THEM.

Be careful anchoring.

No, this is not just a reflexive warning to fellow sailors. Last September I wrote about Anchoring in the Behavioral Finance sense. There's another side to that.

You've probably heard that housing prices are "sticky." That is, the owner sees a house sell on the block for $X, so his thinking is 'anchored' that his house is worth $X too (and ideally more via appreciation.) Thus, when the market starts to fall, this owner may say "I will not sell my $X house for .95$X, that's not the right price. I'll wait." The wait could be a decade, or he may have to sell later for even less.

Similarly, and this is why I mention it now, during a stock downturn people have a tendency to anchor at the peak price of the stocks they bought, or at the purchase price. Example: "If this loser will just go back up to [the anchor price] then I'll sell it and good riddance." Well, the people who say that at the start of a slide can wait a decade or more, or be forced to sell later at a much lower price.

If you hold a stock, and your head says that it's no longer a good one to own, and the pit of your stomach says you wish you'd sold it already-- be aware of the

human tendency to anchoring. Name the demon, and you control it (at least somewhat.) Don't wait for the return to the anchor, get rid of the stock.

No one really knows the best time to buy or sell. The best we can do is use our heads and try not to be carried away by bursts of passion or not challenging our sloppy habits of thinking.

It's time to send this on its way.

If you have any questions, please write or phone. If you want to read more, I've got a web site (see URL below) with archived editions of this letter and some links to other interesting sites. There's also a weblog where I discuss the process and progress of starting the mutual fund.

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

Some of you are getting this as a sample gratis, but in general:

I charge $120/year for this newsletter. If you're not sure you like it, you could subscribe for 3 months for $40.

To keep these investment commentaries coming on time, you can make a **secure online purchase** by following the Paypal buttons on my web site. Alternatively, your checks, mailed to the address below, are always welcome and appreciated.

Take care,

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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

A collection of fine industrial Boilerplate, but true:

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Although I may answer your general questions, I am not licensed under securities laws to address your particular investment situation. No communication from me to you should be deemed as personalized investment advice.

Any investments recommended in this letter should be made only after consulting with your investment advisor and only after reviewing the prospectus or financial statements of the company.

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