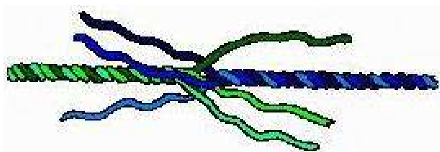
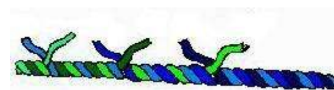


Capital Drain



Rick's investment opinion newsletter April, 2007 v.3 no.4

Hi Readers,

In my new day job, work on getting the fund up and running is proceeding nicely. For the next few hours, though, I'll take a break for my long-standing hobby, writing this newsletter.

Ready? Let's begin. In my opinion:

Executive Summary:

"Overseas" is not an asset class, it's a place.
Winding the spring ever tighter.
Never just one cockroach: loose lending
Credit Check, part III: TransUnion

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:

During a recent long drive, a friend described his investment allocation. It was basically what you hear from the respected oracles of conventional wisdom: mostly stocks, some bonds, and "10% overseas."

I finally realized how to describe what's wrong with that picture**. "Overseas" is not an asset class, it's a place.** Yes, most investing guides talk about it as if it were a separate asset class, but I think those guides are stuck in the inertia of pre-globalization thinking. For the modern individual investor, the asset classes to consider are securities

(stocks & bonds and mutual funds holding them), cash, and real assets (land, buildings, stuff with some usefulness and real cash value in an active marketplace.)

Where those assets are located is a totally separate question. Think about it-- is New York or Chicago an asset class that gets a designated proportion of your investments? I doubt it. Why, then, would we think of London or Tokyo (both huge securities exchange centers) as being lumped with each other but somehow different from similar US securities centers?

I propose that we shouldn't.

Part of the conventional wisdom is OK: stocks give better long-run returns, but bonds are usually more stable, cash is pretty definitely stable, and real assets can be good diversification, especially investments in something useful like owning your house.

Part of the traditional decision needs a second look. Where are the stocks that will give you the best results? Where are the bonds?

At the end of the Second World War, the US economy was more than half of world GDP. Today it's less that one quarter, and it's not the fastest-growing quarter. In the 60 years since the mid-1940s, the developed countries of western Europe have recovered, Japan and Korea and Taiwan have developed, a dozen eastern European countries (held back until the 1980s) are recovering/developing quickly, two new Asian giants are emerging, a dozen smaller Asian countries are developing, Latin America is getting its balance,... I could go on, but I think you see the picture.

It's a new global system of production and of markets, and it's time to think in terms of a new global system of investments.

There's one catch, one detail that *could* make an overseas investment different from a US one: currency differences. Hypothetically, you could lose US dollar spending power if you picked good overseas investments but the dollar rose versus the currencies of the investments' home countries. In the 1990s that happened: a rising dollar made US investments more attractive, and overseas ones less so.

For the next several years, though, I think the currency difference will be helpful for US holders of overseas investments. The last month has seen the dollar's fall quicken, for all the reasons I've discussed in prior months. When you think about where you're likely to find stocks or bonds that will give you good returns, keep in mind that a falling dollar acts as a tailwind, increasing your investment return. That won't always be true, but for a while it's quite likely to be true.

The stocks or bonds of strong global-leader companies or countries deserve your consideration on a level field with their US counterparts.

At least.

In fact, the US stock market's recent record highs while the underlying economic picture crumbles are not very enticing. Stocks in other developed markets might be less vulnerable to a sell-off right now. (Emphasis on developed! Not developing.)

But wait, didn't the Dow just set a new record high? Yes, it did, and that's the problem. The stock market seems to be plowing forward on momentum alone, even

though the economy is running out of steam. The latest quarter's GDP growth was the lowest for years, and the quarter before that was not great. Corporate profits are being reported as 'beating expectations,' but that's pure spin control: the profits are on average just half of what they're been for the past four years. People are still spotting the bottom of the housing market almost as often as they spot Elvis, but the numbers do not yet support the optimism. Oh, and inflation just isn't going away as conveniently as the optimists have expected. The index of leading economic indicators is down now to levels which have always and only been seen in recessions.

This imbalance between a record-high stock market and an economy full of bad news is not good. It reminds me of a spring being tightened and tightened. Will it break in one great ka-SPROING!, or will the tension begin to be released gradually, or will we somehow magically keep tightening it?

Whichever way, I do not want to own any US stocks right now. (So I don't.)

A quick reminder, it's easy to buy US-registered mutual funds and ETFs that invest in quality overseas stocks and bonds.

A big part of the reason that many analysts (and I) are waiting uneasily for worse news to come out, the stock market to fall, or both, comes down to two words: **loose lending**. We've heard about the now-failing loans to sub-prime homebuyers. That those people ever got a chance to borrow that much money is testament to how much capital is looking for ways to get better returns, hoping that the risk incurred won't be too large. In sub-prime loans, we now see that the risk was too large. So, what about the other risky loans? Hedge funds have been borrowing huge amounts, on far easier terms than they could have gotten a decade ago. Shaky companies (shaky while the economy was doing well, mind you!) have been able to sell tons of junk bonds, here and around the world.

Are US sub-prime mortgage borrowers the only ones out of all this loose lending that will get in trouble? Maybe.

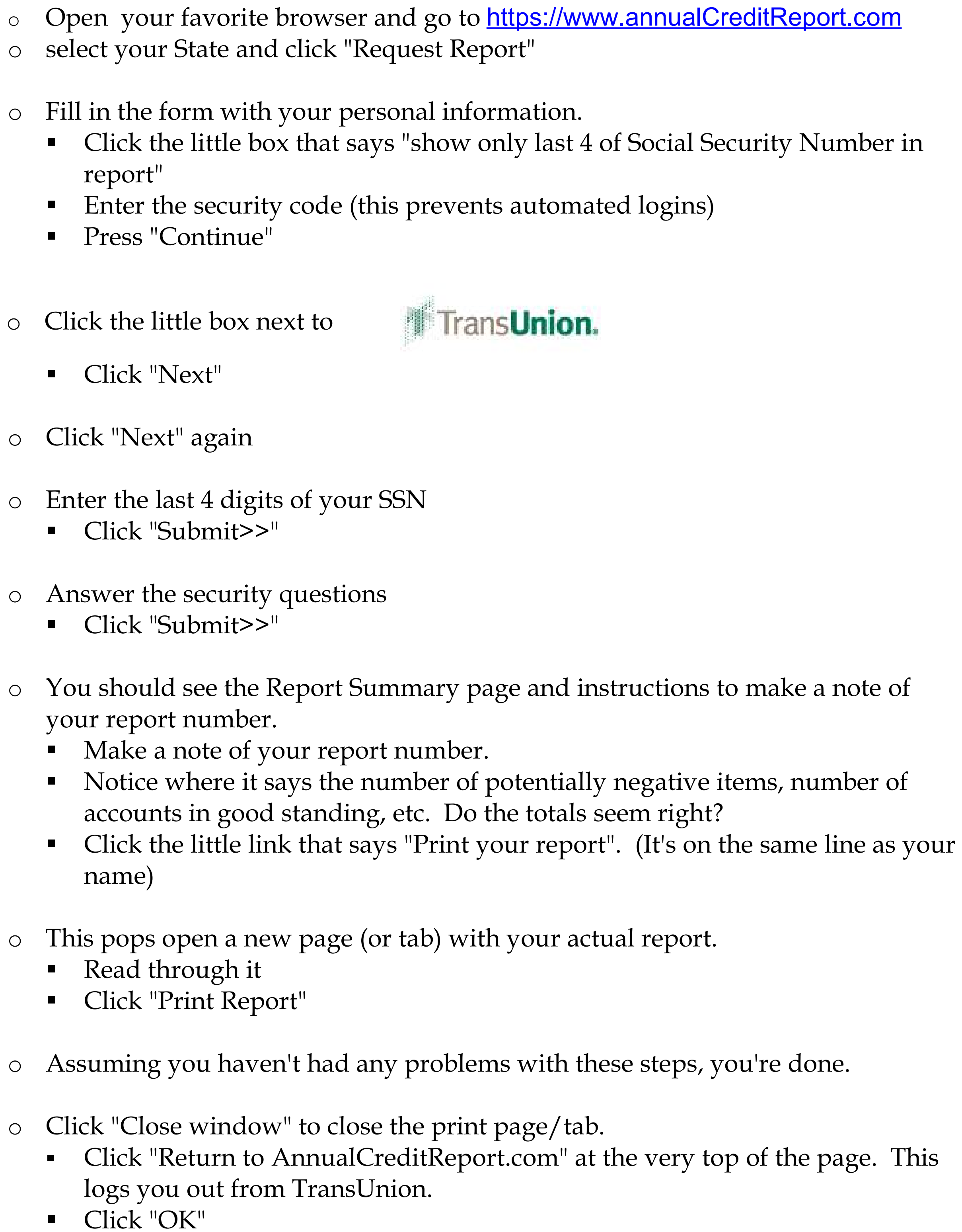
There's a saying, though, that there's never just one cockroach. When you see a cockroach in your kitchen, the overwhelming likelihood is that there are thousands of others nearby that you'll see soon enough.

It's entirely possible that with even the least bit of stress in the overall market (for example, a housing slump or rising inflation or falling GDP,) many other classes of risky borrowers could come out of the woodwork. The fear is that a trickle could become a flood, if the loose lending was too widespread. As some investors lose money in these (suddenly rediscovered to be risky) loans, they may have to sell other assets to cover their losses. The happy cycle of record stock prices begetting more stock investment could reverse. Maybe, maybe not, but I'm not optimistic. I doubt if we'll get any protracted good news for the rest of the year, and the news we do get could be quite disappointing.

This month we finish the cycle of **credit check**ing, this time at the third agency, **TransUnion**.

- 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 

  - Click "Next"

- Click "Next" again

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

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

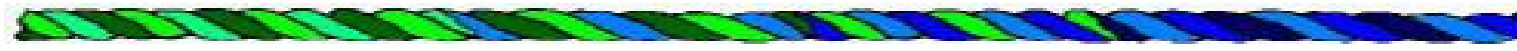
- You should see the Report Summary page and instructions to make a note of your report number.
  - Make a note of your report number.
  - Notice where it says the number of potentially negative items, number of accounts in good standing, etc. Do the totals seem right?
  - Click the little link that 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"

- 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 TransUnion.
  - Click "OK"

- If you then get a message that your session has timed out, ignore it. You're done.
- Close the browser window.



That's all I've got to say for now.

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:

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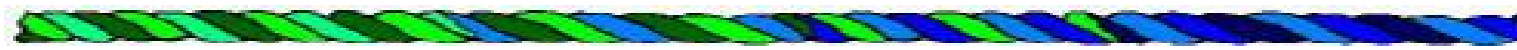
To keep these investment commentaries coming on time, you can make a **secure online purchase** by following the Paypal buttons on my web site. Alternatively, your checks, mailed to the address below, are always welcome and appreciated.

Take care,

Rick



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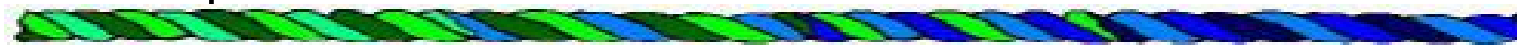
"Our doubts are traitors,
And make us lose the good that we oft might win,
By fearing to attempt."
--W. Shakespeare



A collection of fine industrial Boilerplate, but true:

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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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