

Impressions

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"In a time of drastic change, it is the learners who inherit the future. The learned find themselves equipped to live in a world which no longer exists." Eric Hofer

This time, like all times, is a very good one, if we but know what to do with it" - Ralph Waldo Emerson

Every year the Seattle Times takes a real client and sends them to four or five financial planners to have them create a financial plan. The results are published as a feature article in the paper.

This year Sweetwater's Kim Miller, CFP, was selected to be one of the financial planners. The result was planning reflecting Kim's usual thoughtfulness and consideration of the client's needs.

We at Sweetwater love recognition particularly good recognition but we are more pleased to see an associate honored. Congratulations Kim for being one of the best.

Dennis Gibb

"Those who cannot tell what they desire or expect, still sigh and struggle with indefinite thoughts and vast wishes." Ralph Waldo Emerson

There are times when fear is good. It must keep its watchful place at the heart's controls. There is advantage in the wisdom won from pain." Aeschylus

Five Themes

All the superlatives have been used. Perhaps the hyperbole that accompanies elections will cease and the news media can return to normal breathing. There are no words left to describe the trauma and significance of both the election and the operations of the financial markets. The election of Sen. Obama as President and the extension of Democratic majorities in both Houses are very significant and could be a sea change in American politics and society.

For nearly two years (it seems like ten) candidates for various offices have battered us with plans, nostrums, concepts and ideas to cure problems real and imagined. Some problems were created for the express purpose of gaining votes, some are real and some are still to happen. In the end the problems that held immediacy with the electorate seemed to be those of a traditional nature that seemed resistant

to traditional methods. In the absence of viable solutions the electorate chose the candidates who offered imagination and hope rather than those with traditional experience.

So now the campaign is over and real issues will have to be faced. The promises made to gain votes have to be modified and perhaps broken in the need to govern and of course to survive politically. It re-

mains to be seen if the American electorate, who tend to have a very short attention span, will continue to believe as the reality of the world rudely intrudes. We wish the President Elect, his team and the Congress a lot of luck. They are going to need it in the near term I think.

I have lived through a lot of history but I have had no experience with anything like what has and is happening in the financial markets. Since the news media are beating us over the head constantly with the ups and downs of the markets, I will not bore you with a reprise. It has been astounding, and one statistic shows the damage. In the month of October, the chairman of a big Las Vegas casino firm with operations in the US, and Macao, lost \$27,000,000,000 in a month! That is more than the GPD of some nations!

The unprecedented changes and destruction of wealth are going to bring some big changes in the US and the world. Some will be good, some bad, some appearing good but turning bad and some seeming bad that could be beneficial.

There appear to be five broad trends to look at for the next few years

Regulation

In the ideal world free market capitalism would not require any regulation since everyone would understand the rules, everyone would play by the rules and the markets would correct excesses. This would not be without pain but in theory would work. In such an unregulated free market the classic trio of labor, capital and property would be free to seek the highest return on their assets and the system would be fluid and ultimately fair.

Such an ideal is not possible in a large, diverse economy and certainly not on an international scale. Some regulation is necessary just as some level of taxation is the price we pay for civilization.

No current regulatory body is immune from criticism in the current mess. The SEC allowed the five largest investment banks and the hedge funds to run all over it and removed the net capital rule and the uptick rule on short selling. The result was the failure of Bear Stearns, Lehman and the shotgun wedding of Merrill Lynch.

The Comptroller of the Currency and the Office of Trust Fund Supervision allowed banks and Savings and Loans to engage in increasingly risky lending and to use securities they created as collateral to borrow more so they could lend more.

The Congress, in the forms of Rep. Barney Frank of MA. and Senator Dodd of CT, oversaw the expansion of low quality loans on the books of Freddie Mac and Fannie Mae. They resisted all attempts at reducing the leverage in these two agencies and ultimately both failed.

President Bush and his team knew of the problems and did not respond with effective regulation. The few attempts to reign in the silliness at Freddie and Fannie were stonewalled by Congressional leaders. This is not a political statement. If you think I am wrong, spend some time reviewing the news coverage. To cite one example in 1999 the NY Times carried an article analyzing the extension of Freddie and Fannie guarantees to subprime mortgages. The last sentence of this article said "if this effort turns out to be incorrect it could cause the failures of both companies."

It is a sorry tale so filled with greed, avarice, stupidity and mendaciousness that Dante would be in paroxysms of joy. It gets more sordid as we move forward. It would be natural then for the absence of regula-

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tion to be followed by a thermadorian reaction¹ and impose some new horror like Sarbanes Oxley or worse. The other method would be to not impose any regulations at all and just let the world fall apart and recover on its own.

It will be politically correct to impose more regulations pass laws, at least that has the appearance of doing something. However, perhaps a better long term solution would be to identify some of the basic flaws of the system.

First, unless government does away with all innovation no amount of regulation will ever prevent new abuses.

The regulations that accompanied the S&L issues of the 1980's did nothing to prevent the current disaster even though the causes are similar. There was just enough innovation to skirt the regulations.

Regulation does no good unless it is accompanied by supervision. For example, there has been a ban on naked short selling, shorting a stock you have not borrowed, for 60 years at least, yet in August and September about 5% of the all shares on the NYSE were sold short naked. Where was the supervision?

It costs a lawmaker nothing to pass a law, the cost of enforcing its actions are quite another matter. Often regulation is piled on regulation making supervision impossible and violations endemic. Ultimately there is no way to stop a person who is bound and determined to break the law.

It is said that we cannot legislate morality. I disagree. We need to understand the difference between ethics and morality. Ethics is motivation based on right and wrong. Morality is a system of determining right from wrong that is established by some authority. The usual authorities for this establishment are churches, organizations, society in general or governments. If we accept these definitions, not only can we as a society legislate morality we must do so.

For a long time there has been a misalignment of rewards in financial transactions and the risks necessary to obtain the rewards. If naked short selling is illegal why has no one been indicted? Everyone knows who was short naked. Sure in the last mess some of the executives of Enron and WorldCom went to jail but none of the investment bankers or analysts who facilitated those crooks did so.

¹ The fall of the government during the French Revolution was followed by a reign of terror and almost continuous executions. Finally this terror went too far and there was a counter movement against its leaders. This occurred during July which had been renamed Thermador by the leaders of the terror.

A bond trader on Wall Street in a good market can make several million dollars per year. If they step over a legal or ethical line and get caught (historically a low probability event) they might get suspended for 30 to 90 days and/or pay a fine of several hundred thousand dollars. Big deal! Ivan Boesky one of the biggest crooks in financial history went to jail and found a way to return to the business!

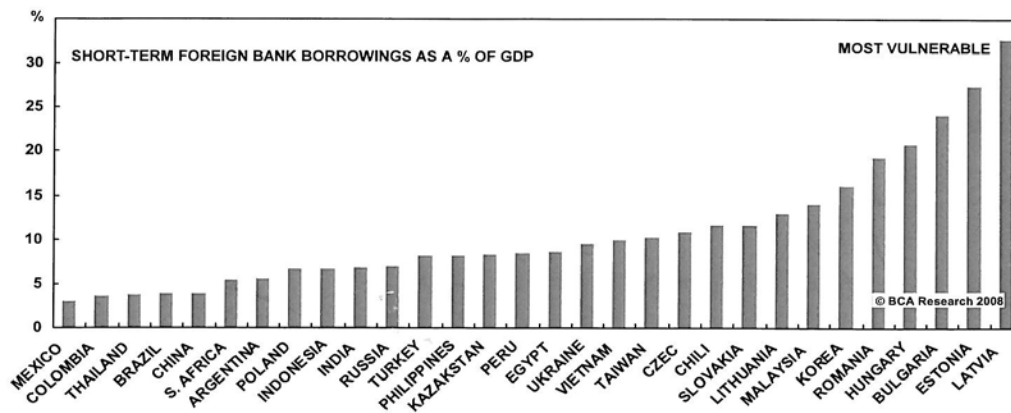
What needs to happen is that rather than passing a lot of new laws without enforcement mechanisms Congress should let it be known that the principals of fair trade, the highest standards of customer care, and respect not only the letter of the laws but the spirit of the law will be enforced. Violations have to include harsh jail time, huge fines and banishment from the industry. Congress has to vote the money to hire the examiners and regulators to enforce the laws.

The principles are already laid down; they are encapsulated in existing laws and are supposedly the standards of conduct already in force.

Second it needs to be stated that no financial institution will ever be required by any public body or law to make loans that the institution believes will cause it harm. If the institution makes such loans they have to absorb them and the management is subject to jail time. The idea that a CEO can run a company into the ground destroying billions of dollars in wealth and walk away with tens of millions of dollars in severance pays needs to end. If the government wants to make loans for social purposes it should make them directly, not hide behind a privately held institution.

Nationalism

It is true that this is not only an American problem it is an international one. The chart below shows that the reliance on short term borrowing and other mechanisms has driven many of the emerging nations to near financial failure.



Source BCA Research

It would be natural for all those nations to begin to look inward and to place national interests before international ones.

This will pose great problems for all nations including and perhaps especially the United States. The likely size of future federal deficits combined with the unfunded liabilities of Social Security and Medicare is going to hamper our actions. We are going to be, in the words of Blanch Dubois, "dependant on the

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kindness of others.” We are going to have to borrow from other nations to finance the results of our profligacy.

Financial pressures will perhaps cause us to rethink foreign policy, military spending and other activities. The hard fact is that most of the federal budget is tied up in legally mandated spending, due to the governing fecklessness of both political parties. The easiest and fastest seeming solution to needing more money will be to leave Iraq, cut military spending, close bases overseas and at home, and withdraw to our own borders. This, while seemingly easy, could be a mistake.

As history has demonstrated when the major powers remove themselves from the world scene the vacuum is often filled by various unsavory characters.

The problem with nationalism is that it can lead to regional conflicts such as Russia and Georgia. The first Gulf War was driven by nationalism and it took the second war to correct the mistakes of the first one. Other nations may be similarly inclined. Other nations have become victims of their own lifestyle. Most of the members of the EU have become so dependant on Russian energy and immigrant workers (largely Muslim) that they are economically emasculated.

National pride has been the father of a great deal of mischief in the world. The Cold War and both world wars were at their roots expressions of nationalism. Globalism has caused a great deal of concern but it is probably long term unstoppable. The US needs to maintain an outward focus or it could find itself trying to come from behind in the next iteration of International movement.

INFLATION

There is probably not enough money in the world to solve all the financial problems existent. After all they were caused by nonexistent money (leverage) and that funny money seems to disappear at times like this. The world banking system and its capital formation process is in tatters and needs to be re-worked. As one evidence of that is that in midst of the financial crisis it was revealed one of the most closely watched indexes in the world LIBOR (London Interbank Offering Rate) was largely a set of phone calls!

Trillions of dollars in transactions are set each day on this rate. Is it calculated by a huge computer somewhere taking in money rates from hundreds of banks? No, it is calculated by Chauncey, a British bank employee calling Algernon at another bank and asking at what rate he was lending (offering) mon-

ey. Then Chauncey called his old Eton school chum, Reginald, and asked him. Then based on all those scientific surveys Chauncey posted the rate! Then they all went out to one of those lunches they have in Britain where they talk like they have relevance.

The Scope of the Problem chart showing rise of debt to GDP since 1957

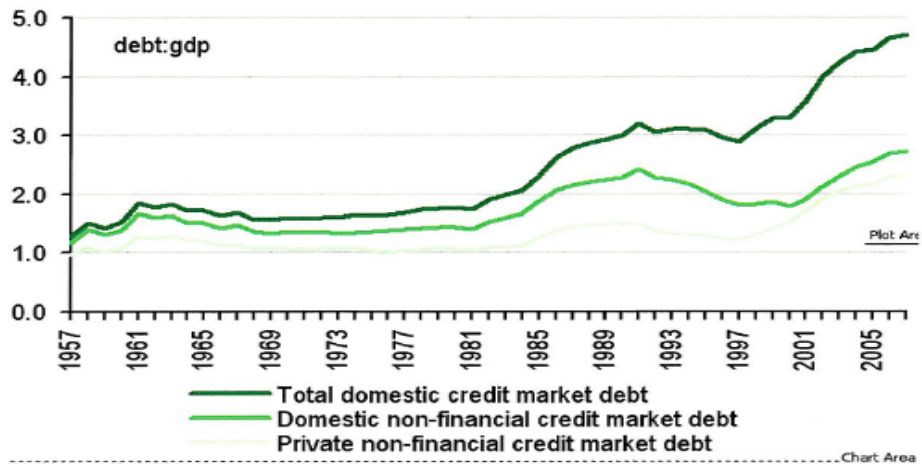


Chart courtesy Andy Lees UBS

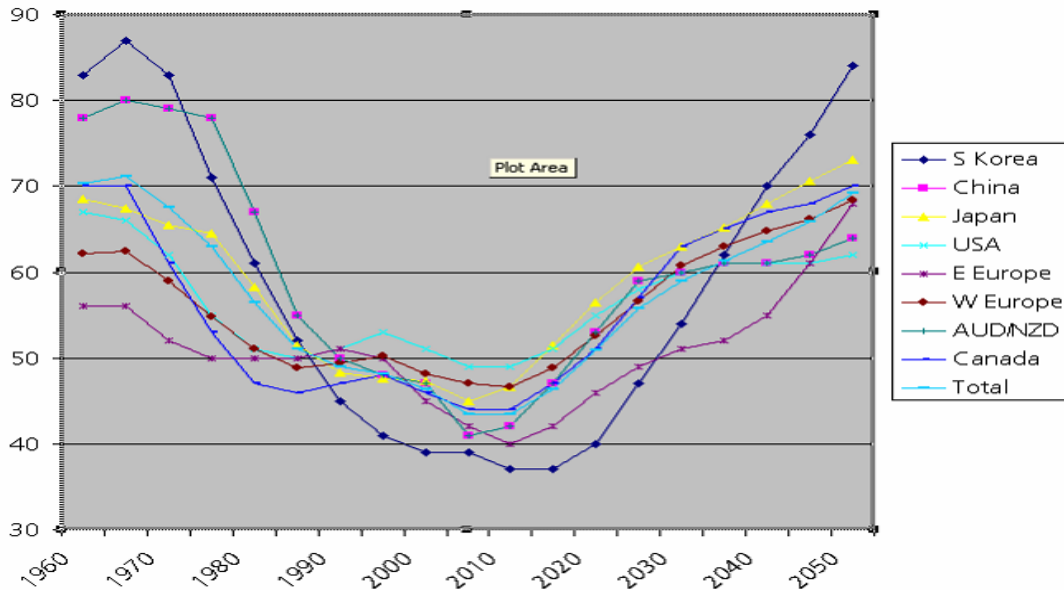
Without sufficient money to bail everyone out, and provide sufficient money for investment bankers and hedge fund executives to maintain their homes in the Hamptons, governments are going to have to print money. We might avoid this fate if we were not facing the problem of Medicare and Social Security. The chart below is taken from international data and shows what is called the dependency ratio.

The chart below shows the change over time in various nations of the relationship between those paying into the system and that dependant on benefits from the system. This chart will determine the flow of capital around the world for many years. When the line is going down nations are creating savings (excess capital) but when the line moves up like on the right side of the graph they are consumers of capital and savings.

Europe recognized this situation 10 years ago and released their formerly ultraconservative pension funds to invest in bonds and stocks of other nations. The demand for bonds and higher returns by these pension funds was some of the fuel for the current financial crisis. The US is behind Europe both in recognizing the problem and in age of population. We have only recently begun to seriously understand the implications of the future. Pres. Bush's failed attempt to create private accounts for Social Security was one attempt to deal with the unfunded liability. The fact that Congress is seriously listening to dangerous fools advocating the end of the 401K plan in favor of government operated retirement for all is a measure of the desperation.

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Source: Andy Lees UBS and CIA annual world book, United Nations

Given the damage already evident and the liabilities we face, we and other nations but mostly the US will have to do one of three things, cut benefits, privatize the investment management of the assets, or default in some way. It is very possible that some elements of all three may be done.

The most effective way to default on an obligation as a nation is to debase the currency and the fastest way to do that is to print money. We are already increasing money supply at rates unseen since the Great Depression. Because the system is frozen this money has so far had low velocity. When the system unfreezes (and it will) the increasing movement of the money will foster inflation unless it is sterilized.

Sterilization will involve pulling the money out of the system via higher rates but that makes the unfunded liability greater. It also requires that there not be a continuing need for the money and this might not be the case. We could be looking at huge inflation a few years down the line. It will not be isolated to the

US the world's money supply is increasing also. In the short term the decimation of capital will place significant downward pressure on prices or deflation.

Chart showing the growth in broad money supply in the US



Source: Bloomberg

Healthcare

There is little doubt that beating in the heart of a lot of folks is a desire to socialize healthcare. Whether it is a single payer (the government) or some system of capitation of prices there is likely to be some movement in this area. The motivation seems to come from three sources: those who believe that health care is a right but not one to be paid for, those who feel that what other nations have done the US should do also, and those who are in the medical field who are tired of the overlapping regulations, price agreements and constantly shifting profit targets.

Whatever happens, it is going to be expensive. First, someone has to pay for those currently uninsured. Second, the administrative costs of shifting to a new system will be very high. Third because a certain number of medical providers will not be able to continue under a new system and they will leave with the attendant economic effects.

Candidates for office constantly pull out some person who has a medical tale of woe as evidence that we need to do something. And the electorate joins in singing yeah! Yeah! As they are told the something will be free.

Whatever happens it will not be free. It will be expensive and it will get more expensive over time. The quality will not necessarily be better. You do not see Americans lining up in Canada for health care. PJ O'Rourke once said "if the government takes over health care it will be delivered with the efficiency of the Post Office and the compassion of the IRS".

The health care situation is a lot like the mortgage situation that led to the current crisis. We are all to blame for the debate over health care. We as consumers use the system to excess. We do not exercise enough. We go to McDonalds and have a Big Mac, large order of fries and to salve, our conscience a diet Coke.

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Doctors and other medical practitioners are so afraid of lawsuits that they perform endless tests. So after three blood draws, two CT scans and a colonoscopy it is finally determined we suffer from terminal hang-nail. Meanwhile our insurance company pays \$15,000.

The drug companies are hamstrung by high costs to produce drugs for difficult to treat diseases, assaulted if someone get sick, dies or even thinks they might get sick by a group of vulture attorneys masquerading as defenders of patient rights. The drug companies find themselves unable to produce vaccines since junk science has convinced a group of people that preservatives used in the process cause autism (a condition with no known cause). The result is that the drug companies have to spread their high costs over fewer products so cost per unit rises.

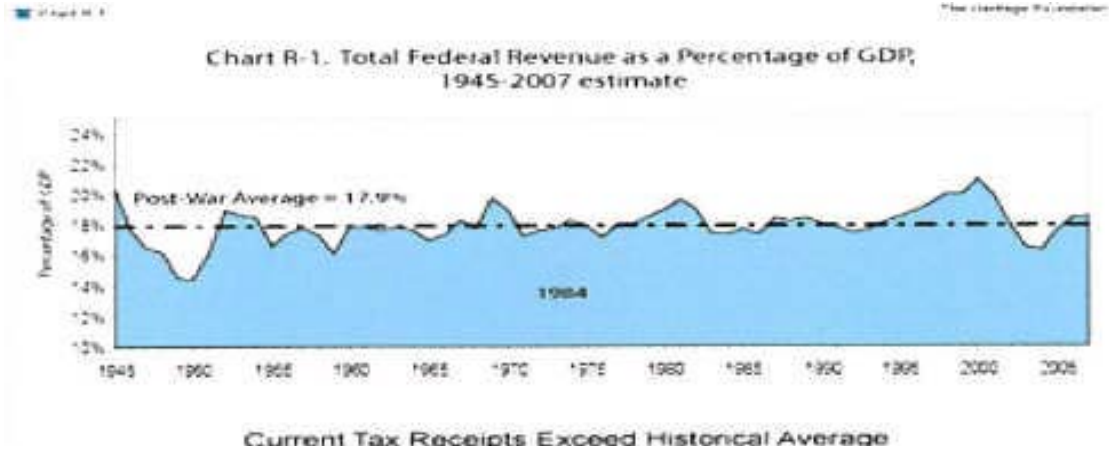
The result of all the cross charges and confusion is fertile ground for sycophants, and demagogues who offer a supposed solution that ends up with more control of each person.

Whatever solutions are proposed to deal with health care, it will be expensive and that expense will not be borne equally or universally. It is estimated that going to a universal health care system would involve direct government control in 35% of the US economy. Given the control the government already exercises in pensions, taxation and employment ceding this much more control places us on a par with the European nations. Think if that is the change we want.

Taxation

There was one thing that was not in dispute in the November election. Whoever was elected was going to be faced with raising taxes. I think part of the reason we are seeing so much persistent weakness is that investors in the US and Europe realize that rates of return after tax are going to fall. They also see that some of the recent strategies such as hedge funds are not going to be as attractive with a 28% capital gains tax as they were with 15%.

Somewhere the government is going to have to raise the money to fund the TARP and the guarantees they have made to the international banking system. All the new programs that everyone seems to want from job security to a living wage (what ever that is) cost money. We are unlikely to default on pensions at present or to reduce the size of government. In fact the election says we want more government and that is expensive. As the chart below shows tax revenue at today's current tax rates are above long term averages and we still do not have enough money to pay for everything!



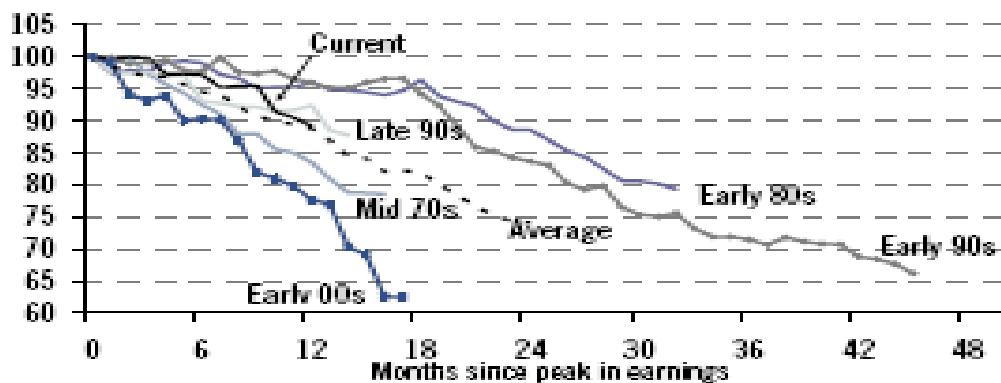
Source: Federal Reserve of St Louis

Tax increases will fall the hardest on those making the most. Capital gains taxes will rise a lot. Those with means and ability to do so will move assets into non-taxable investment- or offshore. Higher taxes will change the financing calculus to favor debt over equity. There will be a greater number of people who will pay no taxes either because of lower income or due to qualification for the earned income credit. All of this will add to the inflationary fires.

Investment Rates of Return

Returns are going to be lower for a number of years. Increased taxation will be one of the components, but earnings growth will slow as the economy feels the full effect of the credit crunch. If taxation on dividends goes up, there will be less incentive for corporations to increase dividends so that element of return will decline. Profits tend to fall from their peaks to the trough of a recession. The next chart shows the decline in past recessions and where we are currently. We have a way to go. Remember in all those past recessions profits could be made back quickly by taking on debt and repaying it later. That will not happen this time.

Figure 4. Global EPS During Earnings Recessions



Source: Citi Investment Research, MSCI

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A good deal of the ROE in companies has come from a greater portion of debt in the capital structure. Debt has lowered the cost of capital reduced equity so that ROE was up. If debt is harder to take on, the cost of capital will rise lowering ROE.²

It is possible that in the future the US may take on the appearance of a European nation in that the focus of companies shifts away from pursuit of superior financial metrics to a combination of financial and social metrics. We may, via government mandate, begin to refocus our employment policies to increase and maintain more jobs at companies. This might, in some part, reduce the move to replace people with technology. If the cost of the new workers is greater than the cost of the technology solution profits and productivity will decline. Unless companies have pricing power, which is unlikely in a highly regulated economy.

I also think that returns to be seen by stock market investors are going to be subprime for some years. I can see the possibility that a manager earning 12% per year is going to be worshiped as some sort of god.

The paradox of the next few years is that lower returns will be better for accumulation of wealth than the last ten years. The decade ending in 2008 has been the worst stock market performance since the 1930's. This has been a decade of reversions to the mean from the out performance in the 1980's and 1990's. Just at the time people should be looking at stocks again they are running to bonds for safety.

These are the themes we intend to invest in the near future but we will be limber and flexible and always be available for your comments and questions.

Good Luck, and Happy Holidays

Dennis Gibb

² Cost of capital is higher for companies with lower debt because the cost of debt includes a reduction for the deductibility of debt. Equity enjoys no such treatment and is therefore more expensive capital

Kim's Corner

Taking a Short Walk

In 2008 it turns out, many investors were taking a long walk off a short pier. The cement overshoes many of us were wearing didn't help either. This was the end result of staying at the party, drinking the punch far too late into the night.

People smarter than me had left the party earlier in the evening having munched a few canapés, partaken only lightly of the punch, sold short and gone home before things got ugly.

Those of us who kept thinking the markets were due for a fall were proven right in our conviction, but dead wrong in having taken any action that would have proven prescient. So now that the shock – and hangover - has mostly worn off, what do we do? The markets have set so many records for volatility, only the most diligent day traders have been making any money.

Enter The Hedge.

In a perfect world, somewhere in a perfect parallel universe, exists the perfect hedge. The perfect hedge goes up as much as the thing being hedged goes down, and vice versa, all without adding to the investor's costs. But let's get real. Hedging is inherently imperfect and of course it isn't free.

In a market as volatile as we've experienced lately, many investors would probably be happy if the value of their risk capital accounts remained roughly the same from day to day. Too many of us have gone long (buying) when we should have gone short (selling) and gone short (selling) when we should have gone long (buying) – sometimes all in the same day. What, you too?

The traditional method of going short is to sell borrowed stock, buying it back after it declines (called "covering"), and pocketing the price difference (minus transaction costs). For those not willing to do the immense amount of research required to decide which stocks to short, Exchange –Traded Funds (ETFs) can also be sold short. ETFs are mostly constructed to follow market or sector indices – selling them short gives exposure to the same market or sector on the down side. An investor could construct a simple hedge of the S&P 500 Index by buying an ETF that emulates the index (sample ticker: IVV) and then selling the same ETF short to protect the long position by a pre-determined percentage. One of the advantages of short selling is that money flows into the account from the sale and some of that money (subject to margin requirements) can be used for re-investment. IRAs and qualified plan accounts (e.g., 401ks) are not allowed to sell short, but there are other ways to hedge long positions (keep reading).

Inverse Exchange-Traded Funds

Shorting a market or sector can also be accomplished by buying (going long) *inverse* ETFs. Inverse ETFs are based on derivative contracts that are designed to give an investor down side exposure to a market or sector. The share value of the ETF moves *inversely* to the value of the market or sector – by owning (long) the inverse ETF, an investor is short the market or sector. If the market goes up 1%, the matching inverse ETF goes down 1% and vice versa.

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There is a growing sector of the ETF market that uses leverage to increase exposure to the desired market or sector e.g., 2 X the S&P 500 Index (sample ticker: SSO). If the S&P 500 goes up 1%, SSO will go up 2%. If the S&P 500 goes down 1%, then SSO goes down 2%. (Not accounting for tracking error that includes expenses charged by the ETF). There are now also many 2 X INVERSE ETFs in which one can invest (sample ticker: SDS). If the S&P 500 goes up 1%, then SDS goes *down* 2%. If the S&P 500 goes down 1%, then SDS goes *up* 2%.

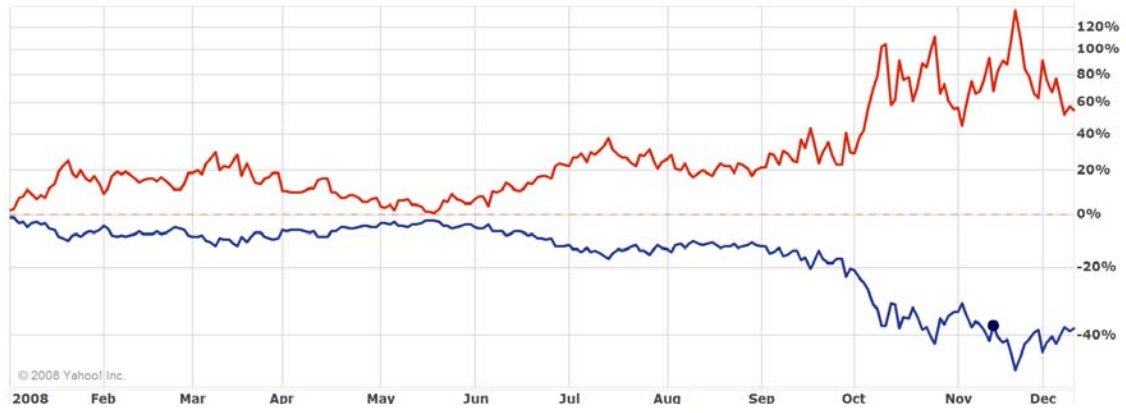
A simple hedge of the S&P 500 Index could be constructed with \$6,700 invested in IVV (long S&P 500) and \$3,300 invested in SDS (2 X Inverse S&P 500). If the two funds are perfectly negatively correlated, the total invested value of \$10,000 would change very little over time. Since we live in the imperfect world (home of the imperfect hedge) the total value would change, but it would remain fairly close to what we started with. Since the 2 X inverse ETF moves twice the percent of the long ETF, one only has to commit about half the amount of funds committed to the long side to implement the hedge on the short side.

IRAs and other qualified plan accounts are not allowed to sell short, but they can buy inverse ETFs – effectively shorting by going long.

With the 2 X Inverse construction, investors can decide how much of a long position they wish to hedge. As described above, the 2/3rd - 1/3rd recipes approximately maintains a total dollar value – very handy during volatile daily swings. A long-bias hedge could also be constructed with a lesser percent commitment to the inverse ETF.

There are Inverse ETFs available for many different market and sector indices. Investors can hedge their existing long positions by buying the inverse ETF that most closely matches the long position. It's a good idea to review charts comparing the history of the long-short pairing to see how closely (negatively) correlated the pairing has been.

The chart below illustrates the negative correlation of the S&P 500 Index (ticker: **IVV**) and a 2 X Inverse ETF tracking the S&P 500 Index (ticker: **SDS**).



Hedging with inverse ETFs won't keep you from walking off the pier, but they can turn those cement overshoes into a life raft. Questions? kimm@sweetwaterinv.com