

The Q.T Report

These thoughts were originally shared with our private clients in April 2011. They are now being shared, unedited, to stimulate discussion of these issues. These thoughts are considered general in nature and not specific investment advice. Contact us with your comments—Barry Strudwick

“Syria II-The Arab Spring”

Just 90 days ago, we predicted political upheaval would have a greater impact on investments in 2011 than news about a plodding economic recovery. What an understatement! By the end of March, a series of events has rocked both the domestic and international landscape, any of which could impact investments for the next decade. As these events are still unfolding, it's premature to draw too many conclusions, but make no mistake, these are potentially major trends.

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short term, the net impact of these two trends has been positive for the U.S. stock market and the Dollar. The intermediate and longer term view is still unclear. However, what is evident is that long standing assumptions underlying investment strategies are shifting. Our challenge will be to monitor the impact of these closely.

Several years ago George Clooney starred in a movie "*Syriana*" where the U.S. and Europe prop up tawdry autocrats to assure cheap oil to the West. We're now watching the sequel in real time called "*Syriana II – Arab Spring*" where the winds of regime change are blowing across the Arab world. No one wants to talk about the camel in the tent which is the economic fate of the Western world hanging in the balance. In this gripping thriller, an inexperienced and idealistic U.S. President is caught on the horns of a moral dilemma: Does he uphold the American Ideals of Liberty and Freedom which could threaten the energy reliant American Dream? Our problem is that this is no airplane page turner. Suddenly this is real time and real life.

Revolutionary fires which weren't even flickers three months ago are spreading like wildfire over at least 10 Arab countries. While the nightly newscasters spout off about the toppling of tyrants; the first question that weighs heavy is "who will fill the power vacuum?" Will they be anti-western? Likely. We might not have liked some of the old guard, but at least a few were on our side. Isn't it most likely an Islamic fundamentalist regime will take control in Libya? And what if an anti-U.S. regime is supported by an energy hungry China?

Revolutions by nature are highly unpredictable and can rapidly morph into very ugly and uncontrollable affairs. Our own American Revolution inspired the middle class led French Revolution. The early brotherhood of equality which attracted Thomas Jefferson, Thomas Paine and George Washington's protégé, Lafayette to actually live in France soon spiraled into the bloody carnage of the Reign of Terror. Radicalism fed on itself and over the next several years hundreds of thousands of innocent people were murdered. Heroes of the

American Revolution, Paine and Lafayette were actually imprisoned for years. The power vacuum was eventually filled by a strong man with aspirations for global conquest, Napoleon Bonaparte who captured Egypt at the ripe old age of 29. Is there an Arab strong man in the wings? Could the instability inspire the global aspirations of China or Russia?


Yemen and Bahrain are already about to topple. The second question is “What if the fever spreads to Saudi Arabia?” Can we prop up the House of Saud, our most important ally in the Persian Gulf? What if they use force to suppress an uprising? So much for the moral high ground.

Since Saudi is the equivalent of the world’s energy central banker, upheaval here could easily be as devastating as the 2008 global financial crisis. So here is the Big Question we hope we’ll never need to know the answer to:

If push comes to shove, will the U.S. be able to reconcile (set aside) self proclaimed political ideals and do whatever is necessary to protect our national (life style) interests? How might China and Russia respond?

In the 80’s, the “Carter Doctrine” said we would do this. Is the resolve still there today? Could the flutter of the butterfly’s wings in North Africa cause a revolt in China or Russia? The question still remains, if mass rebellion erupts in either of these countries, will the West intervene “for humanitarian reasons” if oil isn’t part of the equation? There are some real scary and plausible permutations here. Where is Jack Bauer when you really need him? Stay tuned.

If the riots in the Mid-East weren’t enough, the Mid–West has also erupted with protesters taking to the streets in numbers not seen since The 60’s. But it’s almost the mirror image of North Africa. Rather than an oppressed and poverty stricken underclass rebelling; it’s a firmly entrenched middle class desperate to hang onto entitlements and privileges the real working class doesn’t have. By launching a legislative sneak attack, a cadre of Republican governors has neutralized the power of the powerful unions by spiking their ability to require the payroll deduction of dues.



In the category of “you just can’t make this stuff up”, just like in a real coup d’état, the Democratic legislators from both Wisconsin and Indiana fled their home states and went into temporary exile in Obama’s home state of Illinois.

Why the big squeal? This is not about “union busting”, it’s about the money. Many, many millions of dollars. In states where dues payment has been made voluntary, union membership has plunged by over 90%. This translates to the loss of tens of millions of dollars which are used almost exclusively to support Democratic Party candidates. Would it be too cynical to point out that most of this is used for huge network advertising buys of which the popular TV show political consultants can take 15% off the top? So while the spin of “union busting” makes a great sound bite, where was the uproar when the mega bucks for political advertising buys and commissions weren’t at stake?

Now the fever is also spreading to other states. Empowered by these early results, Governors in other states to include Florida and New York are like the posse riding to save us from the new “Red Menace” of the red ink from government defaults. The new trend favors balancing budgets by cutting spending and union benefits rather than raising taxes. The notable exception is Obama’s home state of Illinois which raised income taxes by 67%. Perhaps the ultimate irony, the Tea Party now endorses Andrew Cuomo!

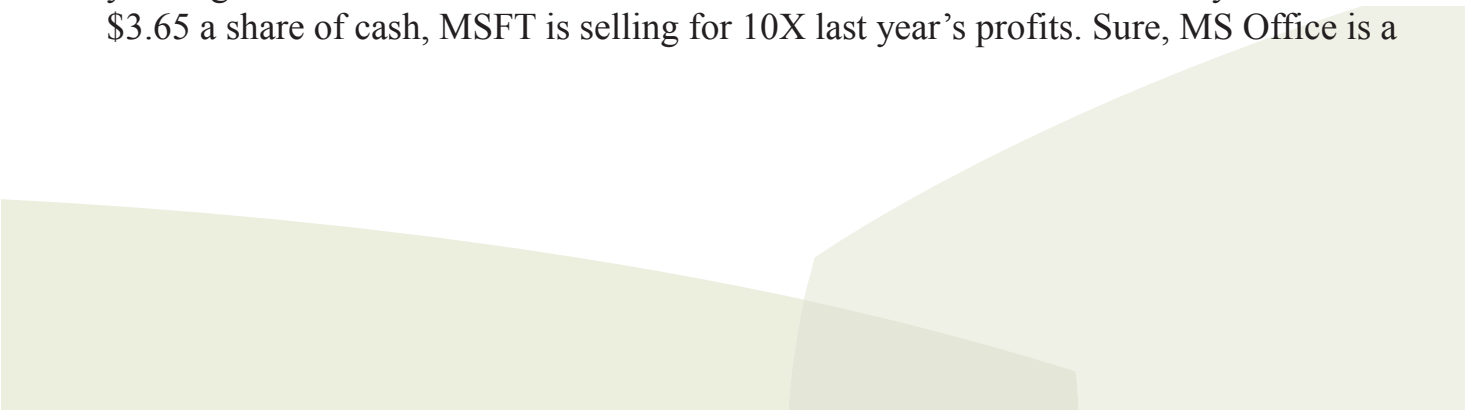
So what does this really mean? If the trend for serious spending cuts gains momentum (and survives legal challenges), the net result could be a stronger Dollar and less upward pressure on interest rates. This would also increase global confidence in the American markets which would be favorable for US stocks.

So how do we play this? Contrary to prevailing opinion, these early short term trends argue for a stronger not a weaker Dollar. Also, as oil, gold and bonds are very fully valued; there is more opportunity in US stocks and the other less “speculative” hard assets.

1.) After increasing our holdings of stocks last fall, our current allocation is 60% stocks, 20% commodities, real estate and natural resources and 20% bonds and cash. We will stay at this broad allocation at this time.



- 2.) A sudden rally in the past 3 weeks resulted in the best 1st quarter for the stock market in more than 10 years. However, before getting giddy about the return of the Bull, put the rose color glasses back in your drawer. The absence of any real economic progress turmoil in the Mid East; the darkening financial crisis in Europe and very low yields on T-Bills make this rally more likely “flight to safety” than a harbinger of a new bull market. U.S. stocks are generally under-valued, but sustainable stock market rallies need to be based on growth in profits, not money seeking a shelter from the global storm.
- 3.) The equity portion of our strategy consists of 50% of selected large cap stocks with huge hordes of cash and an overweighting of 10% in the energy sector to include oil and gas exploration and nuclear energy. Our holdings have lagged somewhat, primarily due to Cisco. We have continued to be under exposed to international stocks and emerging market sectors both of which have shown vulnerability recently.
- 4.) In this environment we strongly favor investing in selected individual stocks over mutual funds. The rationale here is the ability to rifle shoot in on specific balance sheets with tons of cash. You cannot achieve this with the shot gun approach of a mutual fund. While a rising tide might lift all boats, we’re more concerned with the ballast that a strong balance sheet provides in a storm.
- 5.) With all the uncertainty around, our preference is for companies with absolutely huge cash stashes and a culture of acquisition. These companies include Berkshire Hathaway, GE, Johnson & Johnson, Cisco and Microsoft. When viewed together, these stocks provide strong global exposure to technology, financial services, transport, energy and healthcare through companies with established franchises and also massive cash flow generating ability.
- 6.) With increasing political risk and a fragile economy, these companies can withstand a second shock to the global system. This is an environment that continues to favor pristine balance sheets over the potential for growth on the income statement. While these may lag in a short term rally, cash creates a strong defensive bulwark.

- 7.) With a cash stash of \$38 billion, Berkshire Hathaway has continued to make more solid acquisitions and profits have surged to \$13 billion. Last year's big acquisition, Burlington Northern had profits up 40%. Last month BRKB made an "all cash" \$9 billion purchase of the specialty chemical maker Lubrizol. Berkshire Hathaway also has large holding in financial services through its savvy crisis investments in Goldman Sachs and Wells Fargo. The stock options Buffet extracted from Goldman Sachs in the meltdown are now worth \$1.1 billion.
 - 8.) Buffet says he sees the dollar falling over the next 5 years and concurs with our strategy of avoiding bonds and hedging against a falling dollar by buying asset rich US stocks.
 - 9.) In the past two years the world has passed through the "data age" and into the "video era" with 80% of all web traffic projected to be video in the near future. To put this into perspective, the equivalent of 11 billion DVDs per month will pass through the web. Meeting this surging demand will require massive upgrades in broadband infrastructure where Cisco is by far the dominant player. Generating \$9 billion in cash last year, Cisco also has a super strong balance sheet with over \$42 billion salted away. We also like the way it's been aggressively deploying its cash to acquire companies and build on its already dominate positions in cloud computing. Some say Cisco is growing too fast, but when you're the size of Cisco you can't nibble around the edges. While Cisco's stock took a hit this quarter, with its super strong cash flow and price at just 10X next year's earnings, we have been using this as an opportunity to average in on positions.
 - 10.) Johnson & Johnson (JNJ) is another company with a strong franchise and super balance sheet whose stock price is essentially the same as 5 years ago. JNJ has also grown its cash stash from \$ 4 billion to \$27 billion and retired 20% of its stock. It's a crazy world when the market values pretzel companies at 20 X profits while a company like JNJ is trading at ½ that price. This is a great franchise that is printing money.
 - 11.) It's essentially the same story with Microsoft, the company everyone loves to hate. Even though both sales and profits have doubled, the stock is still at the same price it was 10 years ago. The balance sheet is like Fort Knox with \$31 billion in cash. If you net out the \$3.65 a share of cash, MSFT is selling for 10X last year's profits. Sure, MS Office is a
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fading star and they are playing catch up with Apple in the mobile phone market, but it is still very early in this trendy retail game. MSFT initially trailed in the video game sector also, but eventually the XBOX dominated. The new JV with Nokia should chip away at Apple's dominant position. The bigger play will come from its position in cloud computing where it can provide software and support to large scale providers. This is a massive market and less fickle than selling to the retail end user. While we wait, MSFT is paying a 2.5% dividend.

- 12.) GE is also another cash cow with \$20 billion in cash and the stock is selling at 1/3 of its value of 10 years ago. It's also putting that cash to work. Over the past 6 months GE has made \$11 billion of energy infrastructure acquisitions which now accounts for 25% of their \$150 billion in revs. GE is also especially well positioned in our system of crony capitalism where contacts in Washington result in big buck contracts. Jeff Immelt is a close Obama confidant and also his jobs czar. We might not like how our system works, but we'd be foolish to ignore it.
- 13.) Why is there \$3 trillion of U.S. corporate cash held offshore? Irrational tax policy. The U.S. is the only major country that taxes foreign profits when they are brought home. To avoid a 30% tax, Microsoft is borrowing money in the U.S. at 3% to retire stock. This is the rational approach. They are also using domestic cash to retire stock. Cisco is a similar story with 80% of its cash offshore. EBay says 70 % of its cash is offshore. A tax holiday is being debated.
- 14.) We've also tilted our core equity strategy with additional weightings in the energy, financial and real estate sectors. These include oil and gas exploration; the publically listed private equity companies and limited exposure to both U.S. and global real estate.
- 15.) The long term reallocation of money and jobs away from the U.S. housing sector will continue for several more years, but the bottom is finally starting to emerge. The most recent Case Shiller study reveals housing prices are back to 2000 levels in Atlanta and other key markets. Nationwide have fallen back to 2003 levels. While "short sales" continue to limit the appetite for new construction at the low end of the market; the demand for luxury housing is starting to reappear. Last year Toll Brothers delivered 560 houses at an average price of \$585,000 and turned a small profit. Since 2006, Toll has aggressively repositioned by cutting overhead by 50% while increasing their cash stash to over \$1.2 billion.

And as importantly, Toll has a JV with Deutsche Bank which has acquired \$2 billion of distressed loans secured with real estate. We like this type of opportunistic investing. With plenty of cash and with fewer competitors going forward, they are in a good position to regain their mojo as the high end buyers' return.

- 16.) Here's a real estate nugget to ponder: nationally almost 1/3 of recent real estate purchases have been for cash and in many markets over 50% of the buyers are foreign. This supports the thesis of foreign money buying U.S. assets rather than T-Bills. Bricks and mortar are a safe haven that is hedged against the currency risk in our government debt. For your run of the mill Mid East or Russian billionaire looking to shift some assets into a more stable environment, doesn't buying a Class A office building in New York or Boston with a yield of even 4% make more sense than owning a Treasury bill with a yield of 3.5% and currency risk? Last year the price of trophy properties was up nearly 20% while other buildings are up just 1%. This trend is starting to filter down.
- 17.) While commercial banks are hamstrung with regulators and profits will be limited going forward, the less restricted Wall Street Mavens are back to making serious moolah like in the good old days. Here is a tidbit to consider; the top 10 hedge funds out earned the combined profits of Goldman Sachs, JP Morgan, Citibank, Bank of America, Barclays, Morgan Stanley and Merrill Lynch! Paulson & Company which employs only 120 people had profits of \$5.8 billion which is more than Goldman Sachs earned with 32,000 employees.
- 18.) One way to participate in this trend is through the stocks of publically listed private equity firms like KKR, Blackstone and Fortress which are up about 7% YTD. The best might be yet to come as the pipeline of IPOs is starting to unclog with 190 IPO filings in 2010 versus only about 50 in 2009. When the IPO window opens, the private equity sector is poised to profit when they foist companies previously taken private back onto the investing public.
- 19.) While on the topic of IPOs, this absolutely vital source of new capital for the U.S. economy is virtually dead due to excessive regulation. In 1997 about 80% of all public listings were small companies. Today the number has shrunk to 10%. Almost all new IPOs are now larger companies exiting from a "gone private" deal. Some attribute this to the absorption of the Four Horsemen of the 80's IPO boom (Alex. Brown, H&Q, Montgomery and Robertson Stevens) by large banks, but the real issue is to Washington. Post Sarbanes Oxley the cost of public company compliance has soared and who in their right mind (other than a lawyer) would want to be an executive of a public company? This is a serious systemic flaw that needs to be corrected. The vaunted innovation of the U.S. capitalist system is slowly being strangled by Washington's red tape.

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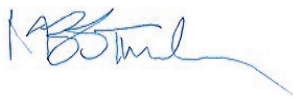
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While these early trends could reverse quickly, powerful catalysts of change have already been released into the system and the genie will not be put back in the bottle. No one knows how this will play out. The good news is that in the immediate short term, the net impact of these two trends has been positive for the U.S. stock market and the Dollar. The intermediate and longer term view is still unclear. However, what is evident is that long standing assumptions underlying investment strategies are shifting. Our challenge will be to monitor the impact of these closely.

- 20.) Can there be a more glaring example of the decline of American capital markets than the recent proposed merger of the NYSE with the German stock market? To add insult to injury, the NYSE was only to get 40% of the deal. Post Enron, we've already lost our position as the leader of the world's capital markets and still Washington wants even greater controls. Access to capital has been America's ace in the hole. Without this competitive advantage, the global playing field is much more level.
- 21.) About 30% of our strategy is allocated to "hard asset" oriented investments such as natural resources, international real estate, commodities and energy plays. The concept here is to make a significant commitment to protect against the long term erosion of the purchasing power of the U.S. dollar and also shocks from the volatile and vulnerable fossil fuel energy sector.
- 22.) In the commodity sector we have holdings of gold, oil and natural gas as well as exposure to industrial and agricultural commodities. While gold and oil have been grabbing the headlines, the strengthening of the Dollar has muted these returns somewhat.
- 23.) However, energy risk has helped our holdings in oil and gas exploration stocks which have boomed by 20% in the last 90 days. With the recent nuclear disaster in Japan and the political uncertainty in the Middle East, this seems to be an opportune time to add to these positions.
- 24.) We're all heard the Progressives rant about wanting to tax the "excess profits" of the oil companies which are cited as the "rich" exploiting the American public. But aren't the majority of the shares owned by pension plans and mutual funds? This means the profits are actually owned by the little guys and not just a couple of cigar chompers on Wall Street.
- 25.) Global supply and demand isn't the only factor at work in oil prices. While the U.S. prints money to fund social entitlements, Saudi Arabia pumps oil. 10 years ago Saudi could balance its budget with oil at \$20, now because of increased social spending to maintain its precarious power base; the breakeven point is \$80 a barrel. Higher standards of living have doubled the per capita energy consumption in the last 15 years. This means less oil for exports and higher prices.
- 26.) So with oil surging to over \$110 a barrel, would you believe the price of Natural Gas actually fell 20% in the first two months of the year? Go figure! But the good news is that this has now reversed in a very strong rally following the Japan nuclear crisis. After taking tax losses in December, we are re-establishing new positions in natural gas. We are also exploring alternatives in coal and will revisit the broader concepts of "alternative energy" which has been disappointing in the past.

- 27.) Speaking of the nuclear crisis in Japan, our position in the nuclear power industry (about 2.5% of most accounts) actually fared better than we might have expected and is only down about 5% YTD. The political realities of NIMBY now make a rally here unlikely over the next several years and we will likely exit our position shortly.
- 28.) While the investment prospects for nuclear have melted down short term, there is still some cool research going on. Bill Gates has funded research for a “traveling wave” reactor which uses old spent uranium rods as fuel. While computer models show much lower risk and construction cost is a fraction of a traditional reactor, post Japan who is going to host the prototype? Certainly not the U.S.! While not an investible idea, look into “Terra Power.”
- 29.) While the state employees whose benefits are being cut are squealing in the streets in Ohio and Indiana, corporations in Illinois are voting with their feet by fleeing to avoid the income tax increases. Already Caterpillar has announced it is in negotiations with 4 states to leave. So why don't they work out a swap; Indiana will take CAT and all its employees and Illinois can take all of Indiana's state workers. Seriously, this is an important trend. Most States realize capital will flow to lower tax environments, which puts pressure on them to cut costs rather than increase taxes.
- 30.) And the sequel to the sequel? Mutant sea creatures emerge in Japan to destroy all the nuclear reactors. And the consumer product placement? Glow-in-the-dark sushi.

In these times of high uncertainty let's stay focused on preserving wealth and not chasing what might be illusionary growth. Ironically, stocks appear to be a better store of value than U.S. Dollar bonds.



Barry Strudwick

P.S. We also thank you for referrals! A few more are always welcome. Let us know if any friends or colleagues might want to talk.

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