

Globalist

Quarterly

October | 2009

The Great Bond Bounceroo

These thoughts were originally shared with our private clients in early October 2009. They are now being shared, unedited, to stimulate discussion of these issues. These thoughts are considered general in nature and not specific investment advice. Please feel free to share your comments with us at www.theglobalistmonthly.com. –Barry Strudwick

Bond Strategy on Target—Still Cautious on Stocks

As the attached reports show, our bond centric strategies, outlined last spring, have been very effective. We remain comfortable that the safer way to recoup from last year's carnage is to invest ahead of liquidity returning to the bond markets. There are simply too many wild cards in this game to handicap the odds of a stock market rally based on an economic recovery. We remain very cautious here, which I'll explain in greater detail a little later on.

Can you believe that it's now been 10 years since regrouping under the Strudwick Wealth Strategies banner down on Eager Street? Over that time we've had quite a run. For the first 8 plus years, we were years ahead of the pack with a strategy based on rapid global expansion, increased energy consumption and a failing dollar. Last year we were again ahead of the pack calling an end to our Globalist Strategies in April 2008. Looking ahead for the next 6 to 12 months, we see a disruptive period of transition as the world adjusts to the reality of a world with much less credit and much more government intervention.

For example, while the trend for the dollar is likely down for the next 5 or 10 years, it's entirely possible that shorter term, the Fed or Treasury, undoing the emergency policies of the last year, could cause the dollar to actually rise short term. This will be a very tricky game, but watch for deflation to be thrown around again.

Our strategy this year has been focused on common sense rather than wishful thinking of a return to the easy credit



The cast of Lost? No, just opportunity seekers

Never- Never Land of 2007. After this bubble bust, worldwide investors moved to the sidelines in fear that the entire global banking system was about to collapse. This summer there was still about \$3.5 trillion of cash stashed

on the sidelines earning virtually nothing in money markets. But we also know that in financial physics, just as nature abhors a vacuum, money will always move to seek the highest (risk adjusted) rates of return.

By July, with fears of a total meltdown fading and inves-

Togo Party?

Emerging Market debt is even higher crazier and is now priced with a yield of just 2.5% above Treasuries. The debt of Togo is almost cheaper than Toledo. So why the sudden enthusiasm? We haven't heard a cogent explanation yet. We'll let others play this game, but for now we'll pass. Don't go chasing after yield in these markets at such narrow spreads!

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Hanging Ten...Thousand on the Dow

tors hungering for higher yields, the lumbering herd of Wall Street started to move back into both the bond and stock markets. After all, it's hard for Wall Street to perpetually charge big fees for sitting on the sidelines. This urge for yield has bid up the absurdly depressed bond prices. As we anticipated, junk bonds and intermediate quality corporate bonds led the charge with eye popping YTD returns of up 49% and 17% respectively. While the stock market has received most of the headlines, the DJIA is only up less than 12% over the same period.

The 6th Inning of the "Once in a Lifetime Bond World Series"

Bond prices are simply readjusting from the panic selling of the past 12 months. Still bond yields are still very high relative to U.S. treasury yields and some sectors are still more unloved than others. We are still seeing the opportunity to put new money to work at 15% to 20% yields. While this is down from the 20% to 35% we saw earlier in the year, it is still very attractive, especially relative to stocks which face a tough environment to grow profits.

The near term future predicted by the bond market is widely divergent from the optimistic forecast of the recent stock rally. Most important, our bond strategies can succeed without significant economic growth. Money simply needs to move back from under the mat-

tress and into the markets. In fact, this needs to happen before you have any real recovery. Why? Because any type of sustainable growth is impossible without liquidity returning to both the banking system and the bond markets.

Stocks: The Bull Snorts (But the Matador Sharpens his Sword)

Money returning to the stock market has lifted all boats indiscriminately, which is probably just a snap back from an emotionally oversold position last spring. There just simply isn't any solid evidence of a real sustainable recovery. The Dow flirting with 10,000 today might be up 40% from the lows in March but simple arithmetic tells us it would still take another 40% surge to reach the 2007 pinnacle of 14,000. At 10,000, the Dow is currently valued a hyper-bullish 28X the 12 month trailing profits. But if we look at values based on the most recent levels of profits actually earned, the price of stocks are currently an incredible 140 X!

So now tell me fellow Swami, exactly who do you see out there increasing next year's profits forecast by 1000% which would be required to bring this barometer down to a more normal 14 X? Wouldn't this require a whole bunch of customers buying a whole, whole lot of stuff?

For now, the current level of 10,000 is

as rational a level for the stock market as any other. Main Street and Corporate America are still assessing what the net impact of last year's massive collapse in all asset values actually means to our collective net worth. New saving, spending and retirement patterns will determine the equilibrium point where the stock market will settle out. We see a range for 20% either up or down from here, with odds of a dip to 8,000 again somewhat greater than a spike to 12,000.



A liquid hard asset

If we see 14,000 again in the short run, we likely have some sort of currency crisis going on.

The Drought of Global Credit Continues

It's not surprising the average American hasn't fully understood how the global banking crisis is threatening the survival of thousands of companies across America. They are focused on their households only.

The lower levels of world wide credit are a major problem for virtually all companies and will trickle down into a lower standard of living for virtually all Americans.

Spin-meisters aside, the "Tea Parties", full of mad-as-hell citizens, are not partisan events. These are the spontaneous howls of graying and panicked Middle America rebelling at the prospect of their golden years turning to cheap, tarnished brass. Call it "Woodstuck." With the finish line almost in sight, the Aging Boomers are both frustrated and scared they will not be able to retire. Collectively, they are seeking a popular voice. This is a real grass roots movement which can become very powerful in a very short time. Healthcare and Social Security are not "partisan" spats. They are retiring Boomer issues which will impact our investment strategies. These developments have to be weighed as we refine our investment strategy going forward.

I'll step off the soapbox and get back to economics and investments. When we first predicted the Great Deleveraging in April 2008, little did we fully appreciate the ripple effect which has turned into a drought in the credit market. We now are just starting to grasp the impact of the dangerous lack of bank credit due to the weakened capital base of our commercial lenders. This is a very serious issue that is shaking the foundations of corporate America and will directly impact investment strategies over the next 12 to 24 months. Our current equity strat-

egy is based on the crisis (and opportunity) that this lack of lending is creating...right now.

Suppose before the bubble burst, your son worked for a solid solar panel manufacturer called Global Gee Tech with \$1 Billion of assets and \$500 million of bank debt. To ride the global economic boom and \$125 oil, Bank-O-Moolah aggressively courted them to lend \$250 million to build a new solar panel plant. Now, one year later with oil prices and the demand for solar panels plummeting, Gee Tech has been pro-actively cutting expenses and is stable (which is a relative term these days.) Still, a slower economy and lower selling prices means cash flow is tight and getting tighter. But Chapter Two is about to unfold and things are about to get suddenly worse, through no fault of Gee Tech's.

Down in the financial district, a special delivery package from Washington has Bank- O- Moolah's executive suite in a tizzy. It's the results of the "stress test." The D+ is worse than Junior's first semester grades from College. After all, BOM has been on a 7 year binge with cheap credit, not just 3 months of cheap draft beer. The Moolah now needs to not only raise more capital (by selling new stock) but the only viable way to fill their capital gap is to also "shrink assets." This is banker babble for telling last

A Trend to Watch

The crumbling mystique of U.S. healthcare system is a major driver for Boomer's going around the world as "medical tourism" is becoming common. With U.S. health care costs out of control, more and more people are already traveling for dental and cosmetic surgery. The next wave? Now others are also traveling for more serious procedures like joint replacement and cancer surgery as well as costs savings of up to 75% are possible.

year's golfing buddy at Gee Tech that the \$250 million loan is getting called in. Our smiling community banker who is the bed rock of the local community is called in to be the hatchet man.

What can Gee Tech do when the bank line is pulled? Since all banks are having the same contraction issue, a lateral move to another bank is unlikely. Gee Tech has three options: dump the new plant at a fire sale price, find a deep pocketed merger partner who can replace the credit capacity, or cut a deal with a private equity firm like KKR or Apollo. These barracudas of Wall Street have been extracting very tough terms recently. All choices are tough in a market when the sharks are already in a feeding frenzy looking to purchase "distressed assets."

Autos, Advertising, Construction, Energy, Entertainment, Real Estate, and Retailing...you name it; right now the impact of the credit contraction is being felt across America and around the world. The particular industry really isn't that important, because this is happening everywhere. Many good companies—through little fault of their own—are being squeezed out of business. Wasn't it the bankers who just last year were virtually giving money away?

Survival of the Fittest: Buffett's Our Boy

From our perspective as investors, this terrible dynamic also creates an opportunity if we focus on the buyers not the sellers. There are a handful of companies with exceptionally strong balance sheets who are in a position and mindset to be the White Knight...at a price...in this market. One of the most aggressive and best positioned here is Warren Buffett's company, Berkshire Hathaway. With over \$25 billion in cash, Buffett is in an ideal position to get great deals from distressed companies. For example this year, at the height of the crisis, both GE and Goldman Sachs came to him hat in hand and paid a huge price not only in interest but also stock ownership. Berkshire is now the largest shareholder in Goldman Sachs, which after repaying its Bailout money, is already back to its old ways of minting obscene profits. Berkshire is also doing dozens of other deals through the

130 companies it owns. It got sweet terms on deals with Harley Davidson and Constellation Energy when they too got squeezed earlier in the year.

Lights are on at GE, Cisco, and Toll Brothers

Another cash rich company with acquisitions on the mind is GE. For example, GE now has a 50% market share in the U.S. wind power sector. Other companies we like with huge cash war chests are Microsoft and Cisco in the technology arena, both of which have over \$30 billion in cash and tech is one area the U.S. can still dominate. We're also beginning to look at how to play the carnage of the real estate industry. Luxury home builder Toll rothers recently went to the bond markets and raised \$400 million which is earmarked to acquire the land inventory from weakened competitors. Our cash rich company strategy is based on the balance sheets and not the short term earnings focus that Wall Street typically has. We also see this approach as being more defensive should the recovery fail to appear to deliver the anticipated profits on time. Don't be confused by deceptive "rates of change" off of depressed floors. What is important right now is the total amount of debt and credit in the system and the world's ability to handle this.

Back to our All-Weather Asset Allocation...

Our bond - centric strategy is working very well and we will continue to hold our overall asset allocation of 50% in bonds, 25% in traditional domestic equities and 25% in what we term "market neutral" which is oriented towards commodities and energy. All sectors have performed well. This is our strategy, and we're sticking to it!

Our bond holdings are in two parts. Approximately 25% has been invested in high yield or "junk" bonds with short to intermediate maturities and the other 25% has been invested in intermediate quality corporate bonds. Both types of

bonds still appear to be very cheap relative to Treasury bills. The returns on the junk bonds have been impressive as the Merrill Lynch junk bond index has rallied 50% since January and is now about 7% higher than immediately after the Lehman Brothers collapse last September.

We focused on four different junk bond investments. Even after huge run-ups over the past 6 months, these holdings still have exceptional dividends. PHK was up 83% and still has a 21% yield; DVF was up 43% and still has a 15% yield; UTF was up 63% with an 8.5% yield. We have recently trimmed our positions in PHK.

However, this has not been without volatility or risk. Shortly after we established our positions here last winter, the entire junk bond sector dropped by 30% in a matter of several weeks, causing some anxious moments, days and weeks as we questioned our analysis. However, our conclusion was that a “bear raid” on junk bonds was the culprit and we stayed the course. However, this type of volatility in the markets led us to delayed entry into these positions for smaller accounts based on a number of factors such as the need for short term liquidity and holdings of CDs.

Going forward, as fear continues to subside, greed tells us more money will flow to these junk bonds attracted by the superior yields. The increase in demand will drive market prices up as investors compete for yield. This is what happened over the last six months and this should continue.

The recent enthusiasm for junk bonds has started a “me too” wave of new comers to the junk bond party which has caused some concerns. Not wanting to be greedy, we have recently reduced by 50% our holdings of PHK which is our most aggressive bond position. While still sporting a 21% yield, we’re more concerned that the shares are

selling at very hefty premium to the underlying net asset value of the bonds. We will continue to monitor, our other positions and will not be afraid to exit.

On the second 25% allocation to intermediate quality corporate bonds, our holdings are split between a more conservative portion managed by Bill Gross of PIMCO (up 11% YTD) and a more aggressive strategy managed by Dan Fuss which is up an incredible 29% YTD. This divergence is exactly in line with expectations as improving credit has been a bigger factor than shifts in interest rates. As discussed previously, Fuss is the expert on picking bonds which will profit from improving credit issues, while Gross is the interest rate guru.

Our “domestic equity” allocation is a conservative 25%, which is up in line with the broader markets. When the equity positions in our “market neutral” sector are added, our total stock exposure rises to a still conservative 40%. However, our strategy here is actually very contrarian as

we’re anticipating the credit squeeze will create unusual short turn opportunities for companies with cash. Many very good companies are already too weak to survive independently because of the lack of normal bank credit. Instead, they will need to either sell off assets or seek partners with access to large hordes of cash. As mentioned earlier, we’ve included Warren

Buffett’s Berkshire Hathaway, GE, Cisco, Microsoft and Toll Brothers. All of these companies have large cash reserves and are growing by acquiring weakened competitors.

Berkshire Hathaway still has \$25 billion of cash even after a string of investments this spring. For top tier companies it’s the date of choice when you’re squeezed and can’t go it alone. Buffett has always been very selective and will



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only do deals with the very best of breed. This year Berkshire has done deals with Goldman Sachs, GE, Constellation Energy, and Harley Davidson among others. More deals will be coming as the banking crunch continues. The stock is also a good value. Over the past 10 years Berkshire Hathaway's net equity has increased by 100% but the stock price is up only 70%.

A company with even more cash than Buffett is Cisco Systems which has \$45 billion in cash and short term investments. Cisco sells what in effect are the picks and shovels the world needs to mine the entire "cloud computing" era that is rapidly replacing the desk top computing age. Cisco's revenues and net income have both increased by 100% over the past 10 years but the stock is down 35% from where it was even before the dot com peaks. The time is right to acquire struggling key companies and to control "cloud computing". Last week they acquired video teleconferencing giant, Tandberg, for 11x next year's profits.



Stacey opens an account with a new client

Our holdings of "market neutral" stocks such as our nuclear, water and alternative energy stocks are about 15% of most accounts. Our intent here was that these stocks would be a hedge against a "normal" global recession. In part the idea was that a Democratic Congress and White House would be very favorable to these sectors buffering a normal recession. Instead, they got battered with everyone else last year. The lard from Washington is now being spread over a wider number of industries diluting the potential Obama effect. Still, our nuclear power stocks are up 33% YTD and have basically recouped all the losses for the past year, so we'll count this a "delayed diversification" effect. Our Water positions have basically tracked the markets, providing no defensive advantage however, they could benefit from increased infrastructure spending. Alt Energy has rebounded strongly in 2009, but is well below its peak lev-

els in early 2008. In the short run, the collapse of energy prices has hurt the cost competitiveness of solar and wind energy but Alt Energy has surprised us by outperformed the S&P 500 so far this year (31% vs. 18%) . We'll chalk this up as another "delayed diversifier". The sector is still trading 25% below where it was 5 years ago when oil was at \$40. So although we won't get the full Obama effect we had hoped for, the sector is still cheap and could excel. We'll let our positions ride for now.

The remaining 10% of our strategy is invested in our dollar hedge positions of commodities, oil, natural gas and gold. Certainly gold has regained its glitter and has broken \$1,000. Oil has rebounded from the post crash prices of under \$40 and seems to be in a trading range of \$60 to \$80. This 10% allocation is the lower end of our long term dollar hedge allocations because while the dollar is likely in a long term decline, if the Fed moves too quickly in its Bailout exit strategy, the result could be deflation and a rising dollar. So who knows right now how fast is too fast?

Most recently we have started adding natural gas positions this summer. With natural gas prices down 50% YTD, we see this as an excellent entry point. The price relative to oil is now the lowest in nearly 20 years. Short run look for high volatility, but natural gas prices will benefit when an actual recovery actually (eventually) occurs. We anticipate dollar cost averaging here, but Natural Gas should be looking good in another year or two. This is also an automatic hedge against a falling US dollar.

What about other non energy commodities? Commodities, which had been as high as 20% of accounts in 2007 are now at about 5%. When prices for all commodities got out of hand in early 2008, we exited totally our core position in April 2008. Because these are very sensitive to slower global growth, this proved to be a very good call with the indices still down 65% since the peaks in 2008. Because of these depressed prices, we have started to rebuild our positions over the last several months. While not skyrocketing, our commodities positions are up about 5% over the past 3 months. Demand for commodities will be weak until a more robust global economy picks up, but we like the cheap prices today and the built in protection against a falling dollar. This holding might lag and drag, but in two or three years mid 2009 will look like a great entry point.

We are playing a rebound in the housing market by investing in luxury home builder Toll Brothers which we started to accumulate shares this spring at about \$15 and is now over \$22. While revenues are down 50% year over year, the stock is up 31% over the past 3 months versus 18% for the S&P 500. Having raised \$400 million of cash in September, Toll Brothers is another example of a company in an excellent position to profit from the weakened position of competitors. Without bank credit, small and medium size builders are dying in droves and are selling land in inventory cheap. Only the strong survive!

We're seeing a trend of Graying Boomers looking to resort real estate as an alternative of the stock market and a potential hedge against a falling dollar. The logic is simple; retiring boomers will seek out warm weather destinations. This means automatic increase in demand as the Boomers are getting older every year, regardless of what the stock market does. After last year's shakeout, the resort real estate values are as good as they are likely to get. Need a bull market barometer? Think luxury resort real estate. Bill

Gross of PIMCO just paid \$25 million for an 11,000 sq. ft. beach house in Newport Beach, CA, which he plans to tear down! Not to be out done, a 21,000 sq. ft. house in Aspen just sold for \$47 million.

Owning resort real estate outside the United States can be an excellent hedge against a falling dollar. But, there is no need to play Indiana Jones, look at "branded resorts" such as Marriott, Ritz Carlton or 4 Seasons. The credit crunch has stopped the supply of new condos but the aging of the Baby Boomers and Washington's increasingly socialistic policies are increasing demands. For more in this topic look at www.luxurylivinginternational.com.

The U.S. commercial real estate market is another story. Values are down 35% from the peak and non performing loans are increasing rapidly. This could be our next crisis over the next 2 to 3 years. The elephant in the room is the mammoth amount of securitized debt coming due over the next several years. This could be over \$150 billion and with the securitization market gone caput, there is no simple way to simply "roll it over." Our Commercial Banking systems does not have the capacity to absorb this much "new debt". No one knows who, what or how it will get refi-ed. The new motto among real estate execs is now "Be clean by '13!" New vulture funds are starting to form here which could be an interesting play.

There has quite a buzz recently about emerging stock markets, which are up strongly so far this year despite the IMF calling for a sharp reduction in growth forecast for '09 and '10. Many markets are up 50% to 70%. Here's a simple question: If the U.S. is cutting

back on consumption, then who are they selling to? To further compound the puzzle, trade credit is very scarce outside the US, so where is the money coming from for these economies to expand during the down turn? We suspect that these thinly traded stock markets are being

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pushed up not by solid economic fundamental but by a herd of global investors seeking non dollar denominated investments. While we are all for hedging against a falling dollar this is the wrong way and wrong time to plant a hedge. Given these markets' heavy reliance on natural resources and exports to the United States, this is a market rally that just doesn't add up.

A more direct way to play the credit crunch is emerging via private equity firms such as KKR, Apollo, Carlyle and others. After licking their wounds last year, these firms are raising new funds for vulture lending and investing. This is a perfect environment for them to acquire cheap assets. The business model is different than the M & A binge of 2008. Rather than acquire the whole company, they are taking minority positions in highly structured (and yielding) deals. Think of these as a "loan to own" approach. Our concern with investing in private equity firms has been potential problems with many of their existing portfolio companies acquired at high prices in 2006 & 2007. Without question there are huge losses in these portfolios, but most of the bad news is discounted in their share prices. These barracudas are now acquiring billions of fresh capital. KKR has \$15 billion in cash. We last exited this sector in June 2007 when the M&A boom were getting out of hand, but with new funds coming in, it's almost time to return.

Here's some more food for thought ... Over the past 10 years we've seen the world change very quickly. Broadband, wi-fi and other technologies have made the world a much smaller place. When I first visited Costa Rica 7 years ago,

phone service was sporadic at best and the nearest cyber cafe required a 25 mile drive. Now, with an iPhone, I can do business while sitting at the café in the Del Pacifico Town Center. Through Vonage, I now have a "Baltimore" phone number in Costa Rica and all calls are treated like "free local" calls. Amazing! With the Baby Boomers reaching retirement age, more of your friends and other Boomers will be traveling and living around the world. With improved health-care and telecom, the tether to the home town is unraveling. The world has changed in the last 5 years; you can do business...or pleasure...anywhere in the world.

Endnote

Only a year ago we felt as if we were facing financial Armageddon, Apocalypse, Katrina, and 9-11 all rolled into one. We battened down our hatches and put our disaster response plan into effect, and we made it through with far less hurt than the vast majority of our fellow investors (and we did massively better than those geniuses at the Harvard and Yale endowment funds.) Well, today, the sun is starting to peek through the clouds, our bond, equity and commodity strategies are percolating nicely, and we're ready to take advantage of the emerging opportunities we see. And if another storm comes, we'll be ready to weather that one, too. Our hope is that the current administration will ultimately appreciate our economy's inherent resilience and let markets, entrepreneurs, and investors do what they do best. If Margaret Thatcher could whisper into Barack Obama's ear, she might very well remind him: "Socialism is fine until you run out of other people's money."

*Barry Strudwick
October 1, 2009*