



STRUDWICK
WEALTH STRATEGIES

THE Q.T. REPORT

These thoughts were originally shared with our private clients at the beginning of July before the passing of the debt ceiling debacle and the S&P credit downgrade. They are now being shared, unedited, to stimulate discussion of these issues and are considered general in nature and not specific investment advice. Please feel free to contact us and share your comments with us. Additionally, please pass this along to other people who might be interested.

–Barry Strudwick



Need a common sense Adviser? We can accommodate a handful of clients who share our philosophy and point of view.

"Habitat for Insanity"

After three years of sloshing through the financial system, the toxic sludge from the 2008 Meltdown has finally been magically transformed into "sovereign" debt. This is just a nice way of saying the Wall Streeters have passed the buck onto our children and grandchildren to pay through higher taxes. Talk about the "con of ages"! While Wall Street is already back to paying itself record bonuses, the combined shoulders of the governments of Europe and the United States are now staggering under the weight of this massive debt. To add insult to injury, the world financial markets are threatening the public humiliation of credit rating downgrades on the U.S. government debt which will raise interest rates and further increase the burden. Make no mistake here: while the politicians from both sides grandstand, a downgrade would be devastating to

the bond markets. Meanwhile on Main Street, we're all waiting to be handed the short end of the stick in the form of higher taxes. Yet despite all these ominous shadows, somehow U.S. interest rates remain at all time lows and many large U.S. companies keep cranking out huge profits. Understanding this enigma points to where investment opportunity might be hiding.

As we forecast earlier this year, political gamesmanship, not actual economics are still dominating the current environment. Because the stakes are so high right now and politics so unpredictable, we recently sold the last of our long-term bond positions to shield against a spike in interest rates. At the same time, we'll hold our cash-rich U.S. stocks, which continue to crank out profits. With modest valuations in the 10X to 12X P/E range, there's more risk of missing a sudden upturn while sitting on the sidelines in cash than there is riding through a possible short-term squall.

While the cable TV news channels constantly rehash the ideology from both ends of the spectrum, this clap trap ignores the core economic reasons why growth has been so punk for the past 3 years. It is not because the government needs to "spend more" or that "taxes are too high." Growth is slow simply because the world already has too much manufacturing capacity relative to the demand. We've been beating this drum now for over 10 years, during which time the stock market has predictably suffered. Adding jobs to existing industries would simply increase the losses companies have already been suffering. Until this pivotal underlying supply/demand imbalance is fixed, businesses won't need to hire more people. It's not too much more complicated than this. Over the past three years haven't we watched as some of this supply glut has been squeezed out of the auto, housing and numerous other industries? On a national level, this causes short-term increased unemployment until new ideas emerge to absorb the displaced workers. At the same time, even unaffected households will cut back on spending until a cash comfort zone returns. This might mean holding a car for an extra year or foregoing a vacation or two. Regardless, lower spending also translates into slower GDP "growth" which can be recast as a "double dip" recession. However, consumers who are spending less are saving more. Our national savings rate is no longer negative and is now 6% of GDP. On balance, aren't slower sales at Wal-Mart a small price to pay for a reduction in our national debt and a stronger dollar? This is all classic "deflationary cycle" analysis and why the stimulus spending to feather-bed state and local employees did not work.

The bottom line here is that the \$1 trillion of government spending spree which ignored the global root problem (too much capacity) was destined to disappoint. However, even after adjusting for "deflation denial," we're sensing something else is also amiss which is further retarding the rate of recovery.

Evidence is appearing that in the decade since the Tech Bubble, securities legislation and more recently the massive **TARP** spending has had the unintended consequences of dangerously altering the "economic eco-system" of the United States. The result is that one of America's greatest advantages over other countries, the free flow of capital to fund new businesses, has been damaged. While these distortions in our "eco-eco system" are very serious, recognizing that they exist may also present current investment opportunities.

Imagine our local business communities as the equivalent of the coastal marshes and wetlands so vital for wildlife and fish. The local business communities provide the nurturing environment for new businesses to mature before going out to the open waters of the public markets. Three years of very tight credit is drying up new business formation in the local communities. The big banks like B of A and JP Morgan Chase continue to report virtually no growth in their small business loan portfolios. Despite Washington's pronouncement the recession ended 2 years ago; fully 65% of businesses with fewer than 500 employees say they will not add any jobs over the next 12 months. Small business is where national jobs are created.

Additionally, this problem is compounded as the once fertile public "IPO" markets have also dried up. Today only 15% of venture capital backed companies go public via IPOs versus 90% in the 1990's. Last year the number of U.S. IPOs was down 70% from the peak 15 years ago. But the same also applies for mature companies as well. Here's another startling stat: since 1997 the number of publicly U.S. listed stocks has declined by a startling 47%! America's "eco-eco system" has turned toxic and America's vaunted entrepreneurial spirit is getting starved for capital!

This is contributing to the slower recovery and also fewer U.S. jobs being created. The impact for America and our American lifestyle is immediate and important. This could be as devastating as filling in millions of acres of wetlands would be on the delicate eco-system of wildlife habitat. If this was the decline in

the breeding habitat of the Blue Footed Booby, rather than creating “millionaire entrepreneurs,” just imagine the nonstop news cycle!

So how are entrepreneurs adapting? Many are opting to be acquired directly by public companies rather than fighting for loans or going public. This also avoids the hassles, expenses and potential personal liability issues arising from the SEC compliance maze. Consider this: last year just 5 cash-rich behemoths gobbled up 134 private companies; a number equal to the entire crop of U.S. IPOs. One conclusion here is that the future growth of America is getting concentrated into a handful of super powerful companies. For the past two years we’ve played this trend by investing in a handful of **cash rich companies** with a culture of acquisition such as ***Berkshire Hathaway*** (BRKB), ***Cisco Systems*** (CSCO), ***Johnson & Johnson*** (JNJ) and ***Microsoft*** (MSFT.)

Sure, these are companies everyone loves to hate, but look at the headline grabbing deals they keep racking up. ***Berkshire*** just acquired ***Lubrizol***, Microsoft snagged ***Skype***, ***J&J*** acquired ***Synthes***, and ***GE*** has been on a \$15 billion buying spree in the alternative energy and natural gas sectors. These are just the big deals; there are dozens of smaller deals.

There’s yet another distortion in the eco-eco system: over \$4 trillion of the essential nutrients called “profits” have been dammed off from returning to replenish the U.S. economy and are sitting in offshore bank accounts. That’s an amount equal to all the budget cuts being proposed for the next 10 years! What if a tax holiday on this trapped money could lure just 25% back to U.S. checkbooks? This would be the equivalent of another \$1 trillion stimulus program without either adding to our staggering debt or debasing the currency through a QE3. What can’t be argued is that as long as this pot of gold remains offshore, the bias will be to create more jobs outside the U.S. These distortions to our eco-eco system need immediate attention and will only accelerate the recovery. The bottom line here is that we need to create jobs that sell U.S. products to other countries in order to restore our wealth. Regulations that instead drive companies away from America will retard any recovery. Here are our thoughts on how this impacts our investing strategy today.

1) With a sluggish recovery and the brewing maelstrom in the bond markets, interest rates could spike up making bonds very dangerous. To address this, we recently **reduced exposure to U.S. bonds** by selling our intermediate

maturity holdings to include Loomis Sayles (LSBDX) and Pimco Total Return (PTTRX.) In most accounts these totaled about 15% of our strategy. This is a short-term defensive tactical move brought on by the potential rating downgrade of U.S. government debt. Until this situation clears up, we will hold monies in "cash."

2) Now largely "out of bonds" we favor a strategy combining the stocks of strong cash-rich companies (55%) and hedges against the prospects of accelerating inflation such as **commodities and energy stocks** (30%) with the balance in cash and short-term bonds (15%). This marks a change in strategy. Recall that in 2009 we were approximately 60% in Junk Bonds.

3) With the Social Progressives jousting with the Fiscal Conservatives we are witnessing the ultimate in "too big to fail" brinkmanship. Apparently very few of our leaders fully grasp the implications of this game of chicken. While a "debt default" is a low probability event, it is one which carries a high level of risk. As importantly, a **credit rating downgrade** can occur even if a political resolution is reached and even if there is no default. This could threaten the stability of the entire global financial market system like Lehman Brothers.

4) Here's why: the U.S. T-Bill rates are the **"risk free"** foundation of a ladder of increasing rates that correspond to increasing risk. Typically, for each higher rung of risk, the market rates increase by a "risk premium" of 1% to 3%. For example, a high grade corporate bond might be priced at 1% higher than a T-Bill and a junk bond several points higher than corporate bonds. If the foundation rate is increased, all the other interest rates will increase also. With T-Bills amounting to 50% of the bond markets, disrupting this base could topple the markets.

5) Washington really is the **"Habitat for Insanity."** Consider this: QE2 created an artificial market for U.S. bonds with one branch of the government selling bonds while another was printing the money to buy them. But you know what is really beyond the edge? Last year Washington bought so many bonds from itself, the excess demand has actually caused worldwide interest rates to fall! Huh??? Think about that one for awhile and then ask yourself "is this sustainable"? Hasn't Washington simply moved the housing bubble over to a U.S. government debt bubble? How could Enron's cooking the books even come close to this scam? Even in the best case scenario, U.S. interest rates

should spike upward when the artificial demand disappears. As a rule of thumb, for every 1% increase, the typical bond's market value will drop by 7%. Increased perceptions of risk by the global markets could magnify these movements.

6) Speaking on aberrations in capital flows, some companies are taking advantage of the artificially low interest rates to borrow money and **buy back** their own stock. This should boost the stock price as it increases the earnings per share by reducing the number of shares outstanding. We are seeing this with companies like *Microsoft* and *Johnson & Johnson*. They can then use these shares to acquire other companies or re-issue again in the future when stock values have improved. Last year 350 of the S&P 500 companies bought back shares. We can take advantage of this trend by investing in companies who are active in buying back programs.

7) So as the world watches the slo-mo train wreck in Washington, what investments appear to offer both relative safety and upside potential? With bonds and real estate out of the mix, the attention shifts to commodities, metals, energy and stocks.

8) Even if the markets get spooked in the short-term, we would rather ride out the storm with solid companies who have tons of cash which should cushion on the downside and who also have solid franchises and will continue to make money.

9) Speaking of recession proof businesses, the most incredible phenomena of the past two years has been the explosion of "social networking." At the end of the day Facebook and others have used "the cloud" to create a worldwide virtual scrapbook. An old investment adage from the Alaska Gold Rush said the people who made the most money were the outfitters who sold the miners their picks and shovels. Today's equivalent is *Cisco* which has a 68% market share for the "picks and shovels" (discs and routers) to the big web hosting sites. With 750 million users posting pictures of cute dogs and lipstick sunsets, there is a massive amount of data which needs to be stored somewhere. Herein lays the opportunity. Do you see a slowdown in Facebook postings if the economy stumbles again? Nor do we. More users, more pictures, more routers, more data storage. Did we mention *Cisco* also has nearly \$50 billion of cash stashed away? When it's not out acquiring adjacent tech companies, *Cisco* has also

repurchased nearly \$8 billion in its own stock. The stock is also cheaper than it was 10 years ago, which makes additional repurchases a great use of cash.

10) **Microsoft** should also be another shock resistant stock with nearly \$22 billion in profits in the last 12 months and it is selling at a P/E of 9X next year's earnings. MSFT has also used a chunk of its \$50 billion in cash to retire \$14 billion of its own stock. Sure the world is moving away from the desktop and everyone loves to hate **Microsoft**, but over \$50 billion in cash will allow them to buy their way into social media and cloud computing as the world transitions. For example, it recently tapped its huge horde of offshore cash to acquire **Skype** which places them squarely in the middle of the social networking business. Please note that Bill Gates, a friend of Obama, used offshore cash to make this acquisition and avoided \$2.5 billion in taxes.

11) **Berkshire Hathaway** had \$10 billion in profits in the past year and now has over \$50 billion in cash in its coffers since both **Goldman Sachs** and **GE** recently repaid early the post meltdown emergency loans Berkshire made to them. The recent acquisition of the chemical company **Lubizol** also fits our acquisition motif, but with this much cash, we'll be looking for another blockbuster purchase or two. Last year's acquisition of Burlington Northern is already adding to the cash reserves. Yes, Buffet is old, but these companies will continue to make huge profits and Berkshire will continue to make opportunistic investments. Sound operating businesses and a turn of cash is a good place to be right now.

12) Not to sound like a broken record about huge profits, acquisitions and retiring stock, but Johnson & Johnson posted \$12 billion of profits over the past 12 months and used part to acquire the Swiss company **Synthes**. They also borrowed cheap money at 2.5% and then repurchased \$3 billion of their own stock which was paying a 3.5% dividend. Pretty good way to take advantage of too low interest rates and a cheap stock market.

13) **Toll Brothers** (TOL) is another company which has taken advantage of the historically low interest rates to borrow \$2 billion and it is now putting this to work in the **real estate sector**. Over the last 12 months, TOL has made \$600 million in direct acquisitions including a recent \$32 million prize location in Manhattan. They have also recently made opportunistic acquisitions of several existing country clubs and golf courses at deeply discounted prices. Additionally

through its Gibraltar subsidiary, Toll has acquired over \$2 billion in distressed real estate loans at heavy discounts which are collateralized with good quality land. While its core luxury home business is slowly recovering, with these types of opportunistic moves, Toll is positioned for both an upturn in its core business and also for a prolonged downturn through Gibraltar.

14) Wall Street and the financial sector continue to rebound. We've played this move through the **Private Equity sector** which is up 42% over the past 12 months. With a three year backlog, many PE firms are looking to create "liquidity events" by selling off portfolio companies via IPOs. Also, about 20% of their portfolios are invested in what are known as Business Development Companies which are capitalizing on the credit drought by lending money at high rates to small businesses. Again, we're positioned to profit from the credit drought. This is an aggressive play and could be hurt in a downswing, but we're also capturing a 5.4% dividend which should take some of the sting out.

15) About 30% of our **overall strategy** is in holdings which should move somewhat independently of any overall economic recovery or recession. This includes commodities, precious metals, oil, nuclear energy and energy exploration stocks. The past 6 months have seen wild swings within the group with such factors as the Japan Tsunami's impact on nuclear energy, the rise of oil to over \$120 and subsequent fall, the ascent of gold to over \$1,500 and also wild gyrations in industrial commodities as the markets look for signs of weakness or strength in China. Most of these will also tend to hedge against a falling dollar, which has gained support from the Euro crisis. While the components might swing, the group has performed its function. We'll maintain this overall allocation.

16) While our 24 hour news cycle has already forgotten about the Arab Spring, we can't afford to forget our lifestyle's perilous dependence on Mid East Oil. We hold about 5% of most accounts in oil which spiked up during the quarter to \$120 a barrel but has since retracted to under \$100. With a sluggish global economy, we'd anticipate oil to remain in a trading range of \$80 to \$100 a barrel. Of course this assumes political stability. We're hedging the political risk by investing in **oil and gas exploration** which posted 40% gains over the past 12 months. Exploration stocks are typically "leveraged" to the price movement

of the underlying energy markets. We're wagering on a falling U.S. dollar, a strengthening U.S. economy and tighter energy supplies here. Eventually all three will happen, the issue is when.

17) We stubbed our toe a bit when our holdings in the **nuclear energy** sector were slammed by the Tsunami in Japan and are down 15% YTD. While the recent developments have made nuclear a less attractive sector over the long term, we'll continue to monitor this for a better exit point. NLR is up a modest 2.5% over the past 30 days; however we still want to exit here.

18) If innovation hasn't stopped, where are the entrepreneurs going? Last year Hong Kong had more IPOs than New York and London combined. So is a company listing in Hong Kong more likely to hire in Asia or Arizona? Is Washington going to capture taxes here? This threat to the American Dream is both more immediate and threatening than global warming, but gets far less attention in the media.

19) While we continue to like the logic of investing in alternative energy. The investment economics remain uncertain. For example, China is flooding the solar market and disrupting the supply/demand curve. This knocks profits out of the equation. The index of **Alternative Energy** stocks remains down 8% YTD with all of this occurring in the past 3 months, despite the spike in energy prices. We exited this earlier in the year and will continue to monitor this sector, but the short-term economics don't appear to match the long-term logic at the present.

20) Leave it to those Aussies! Talk about a national energy initiative, Australia has initiated a carbon energy credit for killing wild camels. Australia has over 1 million feral (and flatulent) methane producing camels which have been known to stampede into villages and bust open toilets in search of water. We hear there is a feral pig epidemic in the U.S., but so far no one has proposed perhaps the ultimate pork barrel bennie, a wild hog tax credit.

21) What Obama is finding out is that Washington cannot wave the magic wand of legislation and sprinkle the pixie dust of stimulus spending and create real jobs. Instead, too much of the **TARP** went to state and local government jobs which did not add to productive output. Why? Growth must come from new

ideas and new businesses which in aggregate are sold internationally. This is the question we need to answer. Then the jobs and wealth will follow.

The recovery remains weak and the bond market is vulnerable. However, it appears ultra large multinational companies are still making a lot of money. We're positioned to avoid risk in bonds and our stocks should also be bulwarks in case of a downturn and very profitable in the upturn.

Please feel free to pass this along to others who might be interested in our approach to investing!

Barry Strudwick
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