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## Third Quarter Investment Commentary October 2009

*"The error of optimism dies in the crisis, but in dying it gives birth to an error of pessimism. This new error is born not an infant, but a giant."* – English economist Arthur C. Pigou

### The Quarter in Review

This past quarter marked the one-year anniversary of the collapse of Lehman Brothers, which sent the financial markets into a tailspin. What have we learned in the interim and what has changed?

- The "too-big-to-fail" idea with regard to financial institutions is flawed. All it does is transfer the risk of failure to the government and ultimately to you and me, the taxpayers. This is replacing private debt with public debt and is morally wrong. Big banks need to be broken up and the regular banking business separated from the investment banking portion. If this means reinstating the Glass-Steagall act, that is fine. Look to the Canadian banking system for ideas on this. Michael Lewitt of Harch Capital summarizes the issue in one sentence: "As long as our society remains intent on socializing risk and privatizing reward, the fewer banks we have, the better off we will be."
- We have enough regulations, but let's enforce them once in awhile. The whistle was blown on Bernie Madoff, but the SEC didn't listen.
- The Commodity Futures Modernization Act should be repealed. This rule allowed derivatives to be exempt from all the rules that affect every other traded financial instrument.
- Overturning the so-called Bear-Stearns rule, allowing leverage beyond 12 to 1, was a mistake. The SEC's 2004 rule change eliminated some leverage restrictions on investment banks in favor of capital requirements by type of asset.
- Continuing to allow high-risk trades to be compensated regardless of profitability is ridiculous. If you take risks, particularly with other people's money, you should be subject to both ends of the spectrum. If private business owners put themselves at risk with business decisions, why should CEOs of public companies be any different?
- Regulating the non-bank sub-prime lenders and mandating (and enforcing) lending standards is vital. No more 125% loans, and someone should actually review the borrower's ability to pay.

Paul Volcker, former Chairman of the Federal Reserve and current advisor to the Obama administration, put forward many of these ideas to the committee on Banking and Financial Services on September 24<sup>th</sup>.

## Looking Ahead

“Someone in the introduction of their book wrote that if you don’t have a clear vision of the future ten years hence, you’re not managing. I couldn’t disagree more. I think if you have a clear vision of the future ten years hence, you’re a psychotic.” – UCLA Professor Richard Rumelt

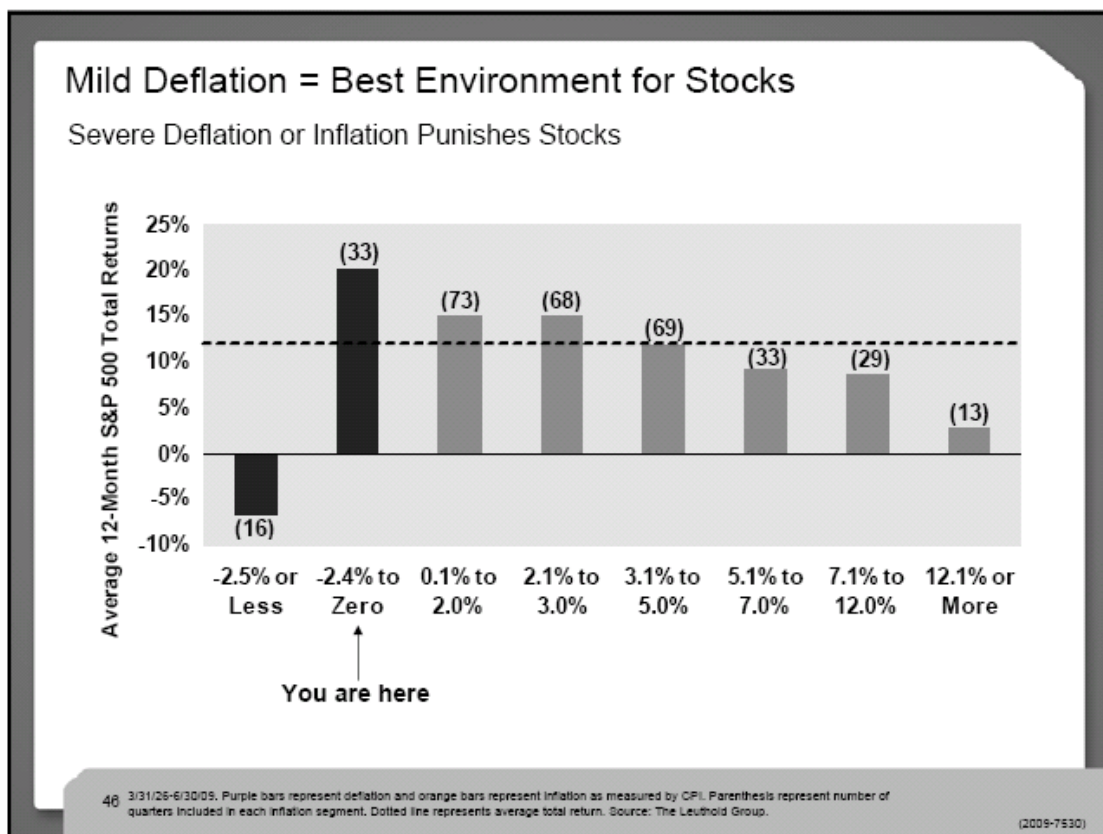
“Greed will come again. But for now, the trend is the other way and it promises to persist for a generation at a minimum.” - Bill Gross, PIMCo funds

So, who do you believe after reading the above two quotes? While both men are smart with tremendous backgrounds, the truth of the matter is that you cannot forecast the future with any accuracy, even beyond just a few days. Just think of your local weatherman or woman. As Yogi Berra said, “It’s tough making predictions, especially about the future.” In fact, many people lately have been making outrageous claims about the future of the American economy. Take retail analyst Howard Davidowitz, telling us at the top of his lungs, almost foaming at the mouth, that the U.S. is “...in a death spiral”, or investor Marc Faber stating that “The U.S. will default on debt or enter hyperinflation,” like Zimbabwe. Are they right? It is doubtful, but they are on television and the Internet because their views are extreme.

Since the market bottomed on March 9<sup>th</sup> the S&P is up over 50%. Bull markets typically start on the expectation of an economic bottom and continue to move higher on the broadening view that an earnings bottom is at hand. It appears that earnings are in the process of bottoming now. Massive write-offs in late 2008 are making year-over-year comparisons easier, which supports the case for a recovery in earnings. A lot has been written about the sustainability of earnings growth without top-line (sales) growth. While cost cutting has tended to be responsible for the trough in earnings, sales growth has been responsible for earnings sustainability. The S&P Industry Average’s sales growth has bottomed on average nine months after the end of recessions, and three months after the trough in earnings growth. The consensus is that the recession ended in June. For the market to move higher from here a sales recovery will be necessary soon. Otherwise, it will be a warning that the recovery in earnings and the economy are suspect. We will be watching the sales trends very closely in the coming months.

Speaking of the future, the big discussion these days is whether our country, and the world, will be experiencing deflation, inflation, or possibly even hyperinflation in the future. Currently, we are in a deflationary environment, brought on by high unemployment and idle capacity at factories. With no wage pressure from employees and slack demand for goods, it would appear that deflation has the upper hand for at least the short-term. While inflation may take hold, depending upon the strength of an economic recovery and the actions of the Federal Reserve, we believe that we are a few years away from those fears. So, how does a slightly deflationary environment bode for stocks? The graph on the following page shows us how stocks have done over the years in both inflationary and deflationary times. It tells us that stocks like mild inflation or deflation, which is where we should be over the next couple of

years. Our thanks to Liz Ann Sonders, Chief Investment Officer for Charles Schwab & Co., for this chart, which was part of a presentation she gave at the recent Schwab IMPACT conference.



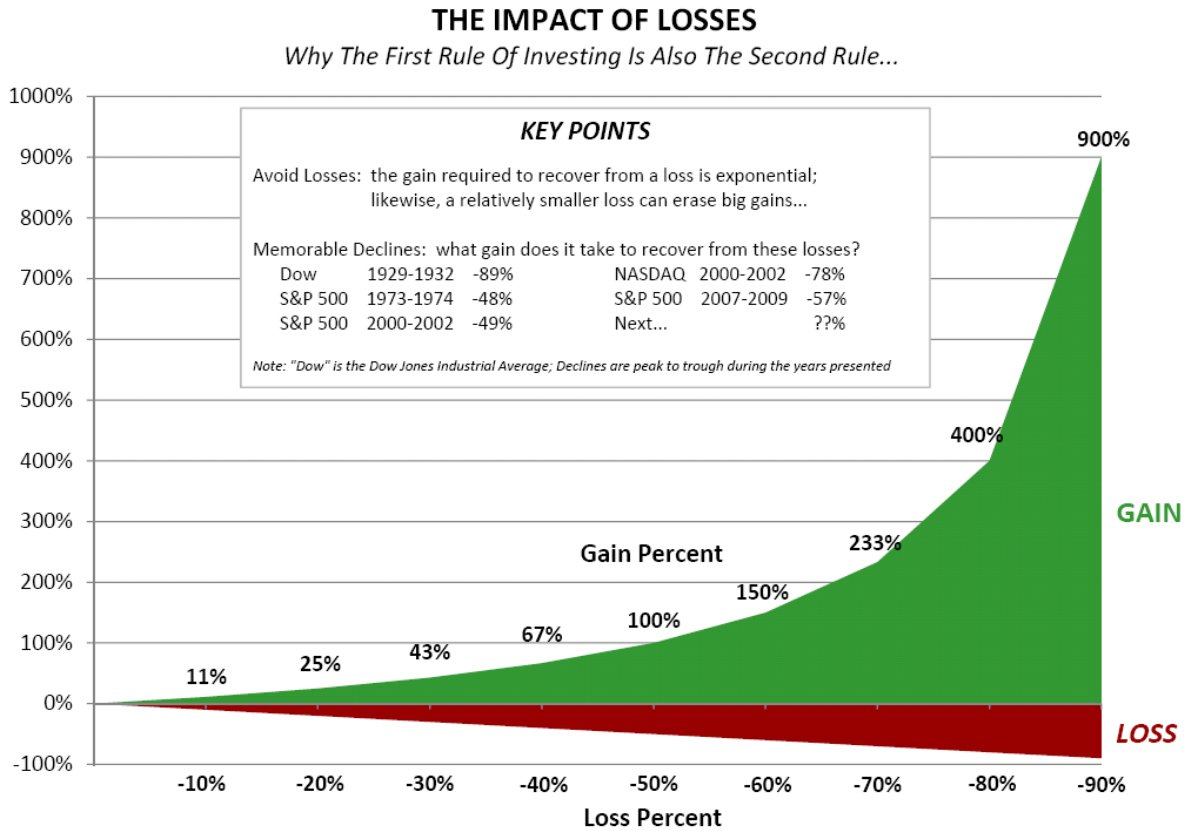
## The Global Economy

We were discussing China in our weekly Investment Committee meeting recently. It seems that everyone expects, or hopes, that the Chinese economy will pull the world out of its doldrums. Certainly, the recent economic data from that country would support those views. However, we are not so sure. In the first half of this year, Chinese banks have made loans equivalent to one-fourth the GDP of that country. Not all of these funds have been put to good use. A recent analysis by Pivot Capital Management states that China's industrialization and structural modernization are largely complete, dispelling the myth that the country will continue to spend vast amounts on infrastructure. We thought of a cinematic analogy to the Chinese economy. In Steven Spielberg's re-make of *War of the Worlds*, there is a scene where a group of people are fleeing the aliens and are waiting at a train crossing. The warning lights go off and the barriers come down. You can see the hope in everyone's eyes as they want to believe the train will carry them to safety. However, the train comes through the crossing at high speed – with every rail car on fire! Terror replaces hope on each face.

## Closing Comments

The last year or so has been a difficult period for investors, even for those who have had great success in the past. As an example, for the twelve months ended June 30, 2009, the Harvard University endowment lost 27%, while the endowment at Yale University declined by almost

30%. It is important to avoid losses of this magnitude in a portfolio, because it is harder to crawl out of the hole. See the chart below.



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The Holidays are on their way, which means our offices will be closed now and then. We are planning to be closed for Thanksgiving Day, the day after Thanksgiving, Christmas Day and New Year's Day. We will also close at noon on both Christmas Eve and New Year's Eve. We hope that everyone has a great Holiday season and gets to spend some time with family and friends.

Kevin S. McGrew   Bruce E. Bower   Paul L. Watkins   Patrick L. Warren   Matthew D. Ison

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