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Dear Senator . . . .

I hope always to be focused long term. At times a curse, as now, but always worth the effort to encourage clients to also take a long view of the markets.

This bias came about for many reasons, but high among them is the belief that Adam Smith, the Scottish economist, was right and a "free hand" will allow markets (and people), not governments, to make decisions best for most in the long term, and that enlightened self interest (key word: enlightened) is not a bad thing.

In my old speeches I said that you have to take a top down view of the world economies first. You are little served doing endless research on companies without deciding first whether the industry and the economy are in decline or expansion. Anyone can find the best ethanol firm, but why bother – the concept is a sham.

Of late, my view has also been one of a 2- to 5-year horizon. I took that position because of solid monetary policy, increased worker productivity, low inflation, rising real incomes and the emergence of new countries onto the global economic stage, among many other factors.

Beneath it all was the enormous engine of money – money from oil, money from commodities, money from stock gains, Silicon Valley new wealth, even sovereign wealth as socialized countries privatized. All in all, it is and was a unique time in our history, as the world was flush with multiple sources of funding. But like college freshmen at their first frat party, the giddy buzz from the first beer could only get better with 10 or 12 more, right? Leverage, new financial products, exotic research around financing social ills and a careless Congress all worked in concert to bring on the well-fueled binge.

I railed about Greenspan with his absurdly easy money, failure to rein in either the dot.com crowd or the banks with the mortgage binge and Congress, well, because it's Congress. But at the end of the day two uniquely stupid cohorts arose; (1) the house buyer without the sense to ask if what they were doing (ARMs, zero down, assumed appreciation, etc., etc.) made sense, and who was further kept in the dark by appraisers, lenders and brokers with no moral compass and (2) my personal favorite, the "Masters of the Universe" on Wall Street – the bright folks who viewed unabashed greed as their entitlement for researching and creating an endless stream of new financial products.

But now its dawn, the porcelain bowl is cold against our cheek and the sheriff is knocking the door down. Some of us never went to the party, probably because we didn't fully understand the new drinks being offered or the research that created them. Among us are a few who warned of poor credits, auction rate instruments and bond "insurance." We bought good firms and held them – and suffered this last quarter far less than the folks who lost 20% or 25% of their portfolios in just 3 months.

Beneath it all is a sea change. We now have to climb well above our long term, 40,000-foot view and consider the strong possibility that like all excesses, this one will create a huge, over-regulated backlash. Note that no government agency ruled that poor credits should fail, auction-rate paper should go illiquid, ignorant home speculators should suffer or that inefficient products should fall victim to imported goods. That was all good old Adam Smith free market economics.

My earliest economics training was in the school of Keynes, Samuelson and the like – the school of "the government knows best and can measure, regulate, discriminate, manage and distribute economic benefit best of all." My epiphany was Milton Friedman around 1967 or so. Congress,

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starting I believe with FDR, adopted the Keynes/Samuelson [theory/practice] model and nurtured it in every Democratic and Republican administration, save Ronald Reagan. We hear it yet again today from the candidates – well wrapped emotion-laden appeals to help us by raising our taxes for yet new programs to remove our accountability. . . and soak the rich in the process.

The problem is, regulation is in the same wind. I believe for a decade or more to come we should also expect

- diminished availability of credit;
- credit unions (finally) regulated like banks;
- banks forced to either increase capital or close;
- government bail-outs like Bear Stearns;
- lower overall economic growth for the U. S. economy while world growth also tapers off
- lower inflation as demand cools for energy and commodities;
- a stronger dollar as U. S. consumers, for a while at least, save more;
- lower tax revenues to states, municipalities and, yes, Washington, reflecting lower growth rates, property values and tax cuts;
- piles of new rules, regulations, agencies and civil servants (is that an oxymoron?)

The change will be grinding and slow. There will still be the new consumer products, old people will still take up cruising, skate boarding and yoga, but the levered world of finance will, of necessity, pull in its horns until the next frat party – or until the sheriff goes home.

I don't see a re-order of the risk/return equation. I believe private equity and venture capital will outperform listed stocks for the simple reason there is so much of the world yet undeveloped – but the excessive leverage, easy-money funding is shelved.

Inflation is not now nor will it be an immediate issue. I wrote a long time ago that if you insist your green beans for dinner be cleaned, cut, packed and frozen, be prepared to pay for it. Food cost increases, with rare exception, reflect both the diet we follow and the insistence on having our work minimized. Sometime soon, I want to do a paper on what we spoiled Americans view as needs, starting with college kids railing against big business while buying the i-Phone. The point is food, fuel, clothing and, yes, housing, take less of our disposable income than ever before – but we want more, bigger, better.

I expect to find a lot of value in this new environment. If a firm can survive this strict environment, then I think it should be a candidate.

Some months back, the point was made that gold had peaked, oil had peaked and the dollar had bottomed. A few of my readers ask how I got there as oil went 10% higher, gold another 6-7% and the dollar hit new lows against the Euro. I got there because I thought I heard the sheriff drive up. My view is not unique – excesses correct. When? Don't know. How much? Probably too much, initially. Why? Well, mostly because a few folks see it and go contrary, as old Adam predicted.

The problem, however, is twofold. There are the perennial bears who get it right once a decade (and get the media) and miss the other 9 years which offsets, many times over, the profits when they are finally right – Granville comes to mind; and there are the folks who listen to the talking heads on CNN, FOX or whatever and don't know what they think because they are always collecting leaves of information while the forest changes around them – and their actions create

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the runs both up and down. We who manage funds have to filter that noise out of our deliberations.

It is damn hard to stay focused on the simple truth that if this economy does a Granville scenario, everybody, even the gold bugs, will lose. Chaos rules and nothing you have is worth anything. Playing defense all day everyday is costly – to your health, your portfolio and your future. I am not unaware of business cycles, downturns, crisis in the industry de jour (S&Ls, railroads, autos, cities, housing, airlines, steel, etc.) These are all what Schumpeter referred to as "creative destruction" – and we Michigan folks know it best. It can come as a double whammy – this time the markets and your house, but it has the seeds of its own recovery in it – so long as we don't assume Congress has a better plan than old Adam. Pain delayed, Senator, is pain compounded. We know you need to be re-elected, so focus on small local issues like ribbon cutting. Building new agencies to do bailouts or rewriting existing laws is make-work, Senator, and fools only the ignorant. Let the markets work – the benefits outweigh and are cheaper than the abuses of the Masters of the Universe and the tenured bureaucrats.

And what of stocks? My old friend and money manager extraordinaire, Stan Rulapaugh, kindly remembers a Keynes quote I used some time back and put it in his newsletter. Never has this Keynes analysis of the stock market been more appropriate:

> "Professional investment may be likened to those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photo-graphs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preference of the competitors as a whole; so that each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view. It is not a case of choosing those which, to the best of one's judgment, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences [sic] to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practise [sic] the fourth, fifth and higher degrees."
>
> *John Maynard Keynes*

Thinking of the Masters of the Universe on Wall Street who invented all the financial Instruments of Mass Destruction, Stan titled his newsletter with a phrase I wish I'd thought of:

"Research causes cancer in rats."

The rats are some pretty fat cats. Stan didn't say to stay in stocks, but I am.

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