

## MORE BUBBLES

April 27, 2010

Three years ago I wrote a piece entitled *Rolling Bubbles*, which envisioned a forthcoming financial environment of going from one “bubble burst” to the next. The obvious conclusion for investors was to anticipate and avoid bubbles, each having the potential of destroying half a life’s savings.

I am enclosing a copy of that piece for you as a “re-read,” not to flaunt that we “got it right,” but rather to reiterate our views and put our strategies in context.

The thesis behind our current view is quite simple: as Americans, we own 25% of the world’s production and 50% of the world’s wealth. This disproportionate level of wealth must be corrected either by increasing production dramatically or losing wealth.

In the business of protecting and growing wealth, this disequilibrium between wealth and production becomes a critical issue for us, especially when a significant part of our analysis must be conducted through the lens of dynamic political change that is sweeping our country.

Can we dramatically increase our productive capacity? We believe we can if we are able to invest our wealth in an economically free environment where incentives provide the ingenuity for innovation, good management and risk-taking. This has been the American recipe for growing profits, increasing wealth, and achieving the highest standard of living known to man. As a society, however, we have been gradually diluting this recipe through an increasingly progressive tax code, whereby currently all of our tax revenues come from less than “half” of our taxpayers. Already the most productive 1% of Americans carry more than 40% of the tax burden. Under the new politics of change, this tax burden will soon be dramatically increased for the upper 5% of Americans, further destroying the incentives for investing--again diluting the American recipe.

Additionally, our new government is taking over (either by outright control or through regulation) the means of production in the automotive, financial, and healthcare industries. History has shown that government-controlled businesses have a poor record of success. Just look at the U.S. Postal Service, Fannie Mae, Freddie Mac, Sallie Mae, and Medicare as clear examples.

The Obama administration strongly believes that exporting is the key to growth of production. This makes sense if we achieve that goal through competitive innovation and efficiency. Unfortunately, our government wants to increase exports by having our competitors revalue their currencies (a convenient way of devaluing our own dollar). A devalued currency will simply diminish wealth along with our standard of living. American companies with overseas means of

production are also slated for higher taxes in an effort to discourage multinational operations. (So much for innovation and efficiency.)

Frankly, our analysis places a low probability of success in growing our productive capacity to match our levels of wealth. The disequilibrium between production and wealth seems, instead, destined to be corrected through a decline in American wealth. Accordingly, our job of managing your wealth in such an environment is causing us to explore new tactics. This is the reason why foreign securities and precious metals are finding their way into portfolios. As wealth can be lost in many ways, we need to be constantly aware of increased risk levels inherent in overvalued stock and bond markets, inflation, deflation, tax increases, regulations, and currency devaluation. Our tactics must be anticipatory rather than reactive, and our scope of concerns must now include global considerations in addition to our usual domestic ones. The complexities have grown exponentially...but that's what keeps me in this business. Investing is truly an endless challenge.

Looking ahead, we see continued stock market strength for a few more months. A unique confluence of circumstances tells us that corporate earnings will continue to surprise on the upside. We now have people advancing income, whenever possible, into this tax year in an effort to pay taxes at this year's rate rather than next year's higher rate. This is adding to this year's economic numbers, which are already benefitting from the government stimulus initiatives on top of a normal inventory cycle turn. All of this is hitting corporations while they are "lean and mean" and reluctant to add costs. The result?—Unbridled profitability.

We must remember that we are stealing growth from next year, a year in which stimulus packages will likely end. We also need to remember that many investors will choose to sell in order to pay capital gains taxes this year, rather than next. This is now a market on steroids, and "hunting" for stocks to buy is fun again. While the hunting may be good, we must plan to "pack up and leave" before the sun goes down.

The bond market story is more critical. We see a Federal government with a surging borrowing-appetite of \$2-3 trillion, not to mention states like California, New York, Michigan, and Massachusetts being in dire need of money. This demand is on top of normal business and mortgage borrowing needs. If our Federal Reserve decides to print money to help accommodate all this borrowing (monetizing the debt), we will likely experience a much weaker dollar. As you can see, we are now putting in some of the pieces to hedge against this probability.

We are also purchasing securities that will hedge the short-term effects brought on by implementing a Value Added Tax. Our guess is that this consideration will gain credence as the months go by...

I hope this piece gives you a better idea of our tactical plan. After all, we believe that through our macro-economic proactivity, we can generate a decent return for you. Admittedly, times have changed, but so have our tactics. Like Cinderella, we must be sure to leave the ball before the stroke of midnight.

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Enclosure