

UNWINDING REAGAN

February 19, 2009

Being on a business/leisure trip for an extended period of time is indeed a luxury. The luxury part of the equation comes not from luxurious accommodations but rather with having the time to read, think and sort things out. Perspective is the by-product of such an experience, and can only come about through quiet, reflective “thinking time.”

The last four weeks have been packed with news surrounding the transition of power in Washington and the ordering up of the specifics of “change.”

During the first week of the transition period, I was one of 20 participants fortunate to be invited to a private symposium hosted by one of Wall Street’s titans, a founder of a successful family of mutual funds whose name will go unmentioned. Participants came from as far away as Dubai and Singapore and included some of the most respected names in economics and investment strategy in the United States. Our group included an ex-Federal Reserve member, corporate CEOs, an astronaut and John McCain’s roommate for a couple years at the “Hanoi Hilton”. I was truly humbled by the stature and accomplishments of those present and by the stories of sheer determination and courage. My right of passage to this group was in being early and correct in foreseeing the current financial crises. After agreeing to be open, candid and honest in our opinions, we commenced three full days of discussion and sharing. To a person, there was unanimous concern for the future of our country. While much of this concern centered on our banking crisis and economic vulnerability, most participants feared the new path and attitude of government.

The irony of the experience was the clear contrast between my days and nights. By day, I was engaging with bright minds who probably guided and influenced wealth in an aggregated amount well into the hundreds of billions of dollars. Most of these visionaries were disinvesting wealth and capital into liquid cash hoping to avoid the impending regulation, control and taxes coming from the newly elected federal government. They were all searching for alternatives to what had worked for decades.

Upon returning to my room in the evening, I was confronted with the public media featuring spokesmen extolling the virtues of big government, including stimulus packages and Federal Reserve accommodation. And yes, there was the frequent cry for more regulation of business and Wall Street in particular. The evening stock market report predictably was bad, telling me that, like my day-time peers, most investors were reacting with their feet...fleeing the path of this new power elite which openly rejects tax-cut incentives and small government. If passive investors and capitalists were concerned, so must be their corporate counterparts who shepherd corporate capital. Commentary about cancelled corporate expansion plans and layoffs often rounded out the news for the evening, and as I turned off the lights I was left with one question: can government displace all the fleeing private capital at a rate sufficient to stabilize markets? I was also reminded of the words of the President of the United States just 27 years ago: “Government is not the answer to our problem, Government is the problem!”

27 years ago, the Dow Jones Industrial Average was under 1,000 and America was in a state of malaise with high taxes, a weak defense capability, and government comprising of over 23% of our Gross Domestic Product. Interest rates were 20%, inflation was 14% and the dollar was weak. Like today, we opted for change. Ronald Reagan had been elected on a platform of tax cuts, small government and defense build up. That philosophy provided for a surging stock market, a drop in inflation and interest rates and a resurgent dollar. Over 16

million new jobs were created and government, as a percentage of Gross Domestic Product fell well below 20%. This new direction gave us the basis for an ultimate stock market high of 14,000, 14 times that level reached when the new change commenced.

Granted, it was not a straight-line advance as policies were tweaked along the way through Bush I, Clinton and Bush II, but in essence, private capital enjoyed a friendly environment. Tax rates on capital gains taxes and dividends are today at all-time lows, and as recently as a year ago, the unemployment rate was just 4%.

Perhaps the housing bubble and all its manifestations have to do with Reaganomics, but we think government policies over the last 10-15 years are at fault.

Nevertheless, Americans once again have opted for change. This time they have elected leaders who believe in the policies of John Maynard Keynes, an economist who believed in large government stimuli aimed at individuals (the demand side of the economy). Job creation will be the target of government programs. This new direction is in direct contrast to Reaganomics which relied on incentives (the supply side) to encourage job creation in the private sector and an expansion of profits to ultimately lower deficits.

The two schools of economic thought:

Currently there is a battle brewing between those who believe in government's ability to create economic growth and wealth, and those who believe in private sector incentives to stimulate growth. This battle is reflected in the behavior of markets on a daily basis. We believe markets are now reacting to the rhetoric of our new leaders who openly reject the policies of Reagan. If we indeed unwind the economic policies of the last 27 years, can we expect markets to retreat to the levels of 27 years ago? Can we also expect inflation of 14% and the accompanying high interest rates? Will government's share of the economy go from 17% to 24% or higher? Will unprecedented deficits force us back to much higher taxes later? Are we headed for protectionism similar to the 1930's?

I admit to harboring some of these concerns, but the jury is still out with regard to future government policies and the ideological resilience of our newly elected leaders.

For all practical purposes, the stock market decline should be nearly over. When looking at duration, sentiment, and most historic yardsticks, the market is already discounting a dismal environment. This time, however, it is probably different because it's about discounting the new government. Are they determined to unwind everything or do they stop here? Will a heavy dose of Keynesism economics lead us to unprecedented growth and prosperity? We don't know, but we certainly hope it does. Our guess is that there's more capital that will have to disinvest, and your portfolio is leaning toward hedging that probability.

We have increased our allocation to gold and inflation-protected Treasury securities, protecting against investors losing confidence in paper currencies and/or the credit worthiness of the dollar.

Lastly, we are searching for domestic companies that provide an essential service or product to our society. We want companies that are either 100% domestic or 100% foreign, as multi-nationals are apt to be hit with new taxes on foreign sales or get caught up in tariff wars.

In short, your portfolio structure is designed to hedge against several distinct possibilities, according to probabilities that we establish for each. No one ever said strategic investing was easy, but we believe we're on a road to long-term success while others stumble about. The probable long-term picture is quite clear in our mind, but we will implement strategy only according to what government actually does. After all, we have to understand that Washington can be affected by what the market does. In a free society, the market is often capitalism's most potent and persuasive spokesman. Let's hope others are paying attention to the market's message. The sooner everyone listens, the sooner we can return to the upside.

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