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Trusted Advisor

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In This Issue:

Another Profitable Year for Balanced Value Investing, with Soft Bumps

We are pleased to report that a composite of our discretionary client accounts enjoyed another positive year, beating all US equities and bond indexes during 2007.[1] Better still, this was achieved with lower month-to-month volatility than the popularly quoted investment indexes. As world markets, both for equities and fixed income investment grew more volatile, the relative stability of Trusted Financial's portfolios is a source of comfort for our clients. Only international stocks and bonds issued in "emerging" markets[2] provided better returns, but with greater volatility than was acceptable for our clients.

Recession Predictions Grow- Our Take

Nearly 40% of economists recently surveyed by the Wall Street Journal[3] are predicting a recession, including one of our bond sub-account managers, Bill Gross of PIMCO. If they are correct, it is likely to be an uneven recession in my opinion. US exports are doing well with software and services competitively priced due to a weak dollar. Oil producing states are cashing in, so not everyone is hurting. Still, real estate related businesses, US auto manufacturers and distributors and the financial sector are suffering. The biggest worry for economists is the possibility of a reverse "wealth effect". United States citizens develop a comfort level regarding their financial well being based largely upon the value of their homes and their liquid investment portfolios, such as stocks, mutual funds and retirement plans. Alan Greenspan, in his recent book *The Age of Turbulence,* discusses this phenomenon and how challenging its effect was to the Federal Reserve Board during the technology stock boom of the late 1990's. As the wealth effect of a booming stock market dissipated in the early 2000's, it was replaced by a booming residential real estate market. It is widely believed that the Wealth Effect caused many people to spend on home remodeling, new cars, electronic gadgets and pricey vacations, often financing these acquisitions with home equity lines of credit and second mortgages. Now, with home values declining at the fastest pace in over a decade, and a stalled stock market, economists fear a reverse Wealth Effect. Surprisingly, retail sales held up this past holiday season, although it was no barn burner, either. If home price implosion continues, and/or the stock market falls, will the consumer

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continue buying high definition TV's, I-Pods and other pricey toys? Will businesses upgrade their computers, software and networking? Will they hire additional workers?

At this moment, I side with the school that feels that a mild recession is quite possible. There are meaningful supports to the US economy in place, however. A key factor is a weak US dollar, that is attracting investment capital into the United States. Investors from oil producing nations and big exporters like China and Japan have appeared repeatedly as opportunistic investors in American banks and brokerage firms needing capital infusions. This is not a new process, but it appears to be accelerating. I believe the US real estate markets will also see an expanding demand from foreigners - Canadians desiring homes in the US southern tier, Asians seeking to transfer wealth from less stable regions and investors from everywhere picking up commercial and industrial properties in soft markets. Demographic forces virtually guarantee that some of the more overbuilt locations, like Florida and Las Vegas, will work through their problems, and faster than many anticipate. Can anyone doubt that a wave of retiring Baby Boomers from the North will soon absorb the housing surplus as they seek to spend their remaining days in warmer climes?

American based corporations as a whole have solid balance sheets, many have spent the past few years buying back stock or increasing dividend payouts due to healthy free cash flow. If recession hurts these companies, they are in pretty good shape to weather the storm and perhaps take advantage of less efficient competitors through acquisitions. Alternatively, given the weak dollar, floundering US companies may find themselves the target of buyouts by foreign interests. While this may be uncomfortable for US national pride, it would provide a cushion for stock and bond prices in a recessionary environment.

How Is Trusted Financial Responding to Recession Fears?

Benjamin Graham's "Mr. Market" analogy has been frequently quoted by Warren Buffet. Graham pictured the stock market as a little old man who some days wakes up feeling fit as a fiddle and other days gets up on the wrong side of the bed. On those bad days, he sells every stock he holds because … well because he's mad at the world! These day-to-day gyrations have little to do with the true worth of individual stocks and the companies behind them. A smart investor seizes upon Mr. Market's bad days and buys from him good stocks at bargain prices.

The Mr. Market concept was one of the first ones I grasped in my evolution as a value investor. Therefore, we used last year's waves of panic selling, February and August to be exact, to scoop up what we believed to be terrific bargains in both stocks and bonds. This does not mean we never sell our holdings. To the contrary, we continually evaluate existing positions, and when we feel they are no longer a value, do not hesitate to liquidate and park money in money market funds, awaiting another panic and another buying opportunity.

I honestly do not have a strong opinion as to whether "the market" is going higher or about to collapse. We simply try to commit money when high quality merchandise is available at bargain prices, and hold on, or even add to positions, if the price gets better (goes lower).

Still, if a full blown Bear Market strikes, we must be able to keep our clients (and ourselves) calm. Long term clients have been through a few downturns with us and tend to be patient. For our newer clients, even those who believe in bargain hunting, it may be emotionally challenging to stay the course when popular financial media are shouting "disaster".[4] Thus we attempt to reduce month-to-month portfolio volatility as follows:

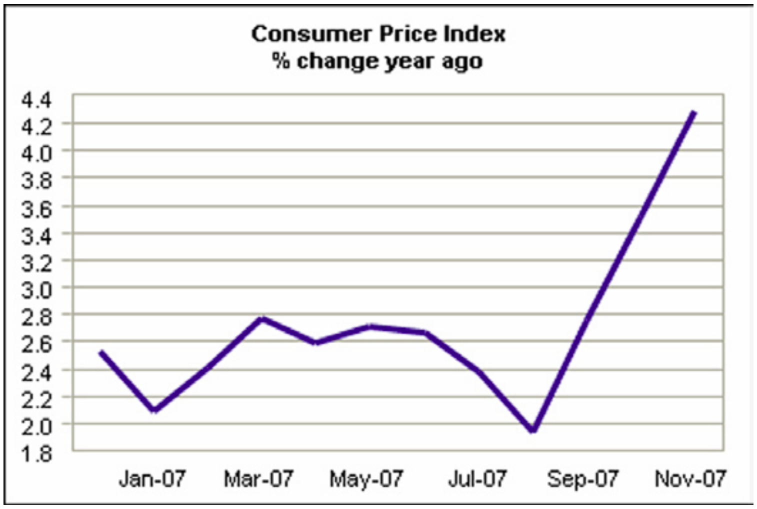
1. Own believable businesses with strong financial characteristics that provide recurring streams of free cash.
2. Diversify so that no single holding exposes clients to significant financial damage, should it collapse in price.
3. Blend many asset classes and types, choosing categories that do not all move up and down together and thus reduce swings in portfolio value.[5]
4. Be willing to hold short term money market instruments for extended periods of time when there is a dearth of outstanding bargains, and to hold our fire until such opportunities appear ready for recognition by other market participants.

<u>One of the most astute things an investment manager like Trusted Financial can do for clients is to be disciplined and to hoard cash until irresistible bargains become available.</u> This strategy guided

us through the last bear market. If, in fact, we are entering another down cycle, I'm confident our reserved and disciplined approach will see us through to better times.

Inflation -It's BAAACK!!!

Official inflation figures for November (see chart) make it difficult for the Federal Reserve to head off recession by further lowering interest rates. Monetarists and gold bugs have predicted a re-ignition of inflation for decades. It looks like they are at last correct. I've contended that something I call "relevant inflation" has been unacceptably high for over a year. The Consumer Price index's "Core Inflation" measure usually has the effects of energy prices and food prices stripped out, meaning that if you do not drive, heat your home or eat then inflation is running under 3%! This is nonsensical on its face. Most of our clients are relatively wealthy. Wealthy people consume more services than non-wealthy people, which is why you see 20-something males crawling around under their cars while older, successful men take them to the service station. Wealthier women have their hair done while financially strapped women hold their heads over the sink while rinsing out colorant. I could offer more examples, but you get the idea. For those who depend on personal services - gardeners, hair stylists, waiters, busboys, trash collectors, car washers , dentists, doctors, veterinarians etc., the cost of living is rising much faster than 2% to 3%. I recently came across the receipt for a vacation condo on Maui from five years ago. Curious, I went to the web site for this condo complex and learned that the cost for the same vacation had risen an incredible 40%, a compounded annual inflation rate over 9%.



With confusing cross currents in our global economy, it is tempting to park money in a CD or money market fund as a "safe" haven. However, paltry yields further eroded by taxes and inflation practically guarantee a loss of buying power when you invest this way. We invite you to speak with us about how we would position your assets to take advantage of investment bargains that are beginning to appear. We have guided investors through more than thirty years of investment challenges. Our approach focuses on loss containment during weak markets, enabling us to have capital available to pounce on bargain stocks, bonds and real estate when others, lacking experienced advice, panic and sell at the wrong time.

Class:
Financial Independence for Women
starts Feb. 21.
Check
www.trustedfinancial.com
(click on Speaking Schedule)
for more information.

Footnotes:

1. Composite returns for discretionary portfolios, net of all fees was 11.92% in 2007.
2. Also known as "developing" nations or once known as "underdeveloped" nations
3. www.BloggingsStocks.com December 11 2007
4. This may be especially difficult for people who have lost their jobs, seen the value of their homes fall or have some extraordinary personal challenge such as the loss of a loved one.
5. I can't handle volatility!!! I think the reason so many of my clients have stuck with me for so many years is due to the fact that I'm uncomfortable with a security that gyrates up and down a lot. Even after thirty three years of investing for myself and my clients, a sudden decline for a holding is disconcerting to me. My clients are people who feel the same way and trust me to give them little exposure to such situations.