



**ATWILL FINANCIAL
CONSULTING GROUP, LLC**
A Registered Investment Advisor



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Running Scared

Why Capital Might Flee America

Charles B. Atwill, CFP®

AS THE OLD SAW GOES, “money goes where it’s treated best.” While public and private debate continues over the role that capitalism and free markets should play in resolving our current financial apocalypse-*light*, it should be remembered that the U.S. capital markets have provided the financial lifeblood to our country for the better part of two hundred years.

In the 18th century, traders of stocks and bonds gathered around a buttonwood tree on the corner of Wall and Broad (where the New York Stock Exchange currently stands) creating an open-air market for securities transactions that financed exploration, constructed railroads and factories, bridged rivers, mined ore, and built a nation.

Capital formation cannot be taken for granted; it requires, among other things, a certain *climate* for it to occur. Pre-

requisites such as:

- the rule of law;
- respect for private property rights and contracts;
- consistent, transparent regulation;
- an appetite for risk;
- and surplus savings,

are as important to capital markets as sun, soil, and water are to plants. Remove any one of these and the living organism withers. As a nation competing in a truly *global* capital market, we run the risk of money fleeing to where it is treated better (i.e., with less government intervention in the markets, adherence to creditor’s rights laws, regulatory transparency, etc.) than it is here in the U.S.

Example #1: The recent case involving Chrysler bondholders is a textbook example of how to scare money away from our shores. Investment funds that held Chrysler senior secured debt (i.e., those at the top of the capital food

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“It would appear, quietly and with deference and politeness, that China has canceled America’s credit card.”

- Rep. Mark Kirk (R-Illinois), a member of the House Appropriations Committee, April 30, 2009

Economic and Capital Markets Outlook

Justin D. Harris, AAMS®

AS VOLATILE AS THE PRICE action has been in the stock market during the first part of 2009, a more significant financial event has materialized in the U.S. Treasury bond market— interest rates are now rising as bondholders become net sellers. In our **Q4 2008 Review and Commentary**, we remarked:

[The] U.S. Government will need to finance a \$2+ trillion budget deficit for fiscal 2009. Foreign creditors (e.g. China) are faced with domestic problems of their own as they see exports to the U.S. and Europe decline. We anticipate the prices of long-term bonds will fall over the intermediate term as the safe haven status of owning long-term Treasuries is re-evaluated by major bondholders around the world.

According to the most recent Treasury International Capital (TIC) Data reports that capture monthly international capital flows into and out of U.S. capital markets, net TIC flows approached a negative \$250 billion for the first two months of 2009.

Because the U.S. is a debtor nation running massive budget and trade deficits that need to be financed daily, the country depends on a continued recycling of dollars by our foreign creditors back to our markets. In the absence of large foreign buyers (who are now becoming net sellers), this creates a major funding problem for the U.S. government. Therefore, domestic buyers must enter the market to make up the difference and/or interest rates must rise to make

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Investor's Corner

Absolute Return Investing

Justin D. Harris, AAMS®

THE CORE CONCEPT behind the AFCG investment strategy is our primary objective to generate positive investment returns through *any* market environment – not just when the stock market is going up and the economy is healthy and growing.

As we know from real world experiences and economic history, markets do not rise perpetually in a steady, linear way perfectly matching an investor's exact time horizon. In reality, financial markets are inherently volatile. Economies do not always expand. They can contract—sometimes dramatically in response to extreme events such as bursting credit bubbles and geo-political crises.

Overall, there is no such thing as perpetual growth in nature or the financial markets. Due to structural economic factors such as rising interest rates and inflation, some asset classes as a whole can remain mired in a bear market for decades (e.g. stocks and bonds) while other asset classes (e.g. commodities) can perform very well on a risk-adjusted basis during the same time period.

In the broadest sense, the fundamental investment approach that advocates seeking positive returns wherever they may be found *despite* what the broader economy and capital markets do during bear market cycles is called **absolute return** investing. In general, an *absolute return* investment process emphasizes capital preservation/liquidity as a first priority before allocating capital in a deliberate manner to risk assets for growth.

Importantly, the *absolute return* investor asks the simple question: “Does the reward potential of this investment outweigh the perceived risks?” This basic analytical framework makes cash the default asset class until favorable investment opportunities are presented. Utilizing this buying discipline helps one avoid the irrational dogma of having to remain fully invested just for the sake of remaining fully invested — even through prolonged periods of economic turmoil characterized by extreme volatility.

Believe it or not, this logical way of thinking about selectively deploying capital from a core holding of cash to riskier investments for growth potential is the *opposite* of how most conventional strategies have traditionally invested. This conventional approach is generally referred to as **relative return** investing.

With *relative return* strategies, positive investment performance is predominantly determined by exposure to sustained market price movements in one direction—up. Long-only mutual funds, passive indexing, traditional asset allocation, and the familiar “buy and hold”, are all com-

Key Characteristics of Absolute Return Investing:

- Strategy seeks to provide positive returns during any economic environment—not just the good times
- Freedom to invest in a broader array of asset classes (not limited to stocks and bonds) for diversification
- Highly opportunistic; looks for favorable risk/reward profiles in both traditional and alternative assets
- Designed to reduce portfolio exposure to extreme downside volatility amplified in bear markets
- Emphasizes the realistic time horizons of the non-institutional investor

monly used *relative return* styles of investing. That is, they all ultimately rely on markets trending upwards in a nice, predictable fashion over the nebulous “long-term” to provide satisfactory returns. Problems arise when markets do not cooperate, and the “long-term” — as in a decade or more — becomes a much longer time period than the average investor may reasonably have available to recoup losses to meet his or her financial goals.

A significant amount of portfolio volatility to the downside creates a very tangible and emotionally unsettling loss in account value that can make prudent decision-making even more difficult. Avoiding the major risks that contribute to large portfolio losses becomes of the utmost importance to the overall investment plan — particularly when your time horizon is shortening each year or you are making portfolio withdrawals for income.

With *relative return* strategies, if your investment time horizon fortuitously lines up with a generational bull market in conventional stocks and bonds (e.g. 1982-2000), the *relative return* portfolio should generally do well. Conversely, if your time horizon happens to coincide with a decades-long, inflationary bear market in stocks and bonds (e.g. 1966-1982), then the conventional portfolio's performance will most likely suffer. Identifying where the markets likely are in these secular (long-term) bull or bear cycles and taking reasonable measures to adapt one's portfolio accordingly is integral to the *absolute return* concept.

Relative return strategies contain an inherent bias to keep money fully invested while severely discounting (or ignoring) structural market cycles and economic problems that create periods of excessive financial risks.

An *absolute return* approach acknowledges the cyclical nature of markets and economies which, in effect, helps orient an investment portfolio with the prevailing economic currents and market trends — not *against* them.

Economic and Capital Markets Outlook (continued)

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U.S. debt a more attractive investment.

Unfortunately, in an attempt to keep interest rates artificially low by propping up bond prices, the Fed announced its plan in March to become the buyer of last resort for as much as \$300 billion in treasuries over the next six months. This caused bond prices to rally, temporarily, further distorting the markets. Since mid-March, market participants have shrugged off the Fed's actions (termed "quantitative easing") sending interest rates higher.

Long-dated U.S. debt securities are becoming increasingly unattractive as an asset class to holders and potential buyers for several reasons:

1. **Currency risk** – market participants are realizing they will be re-paid in cheaper dollars as the government attempts to inflate itself out of deep debt hole.

2. **Interest rate risk** – bondholders are seeing the principal value of their bonds decline as interest rates rise to reflect the huge new supply of U.S. debt being issued to pay for the Obama Administration's spending plans amidst a severe economic recession.

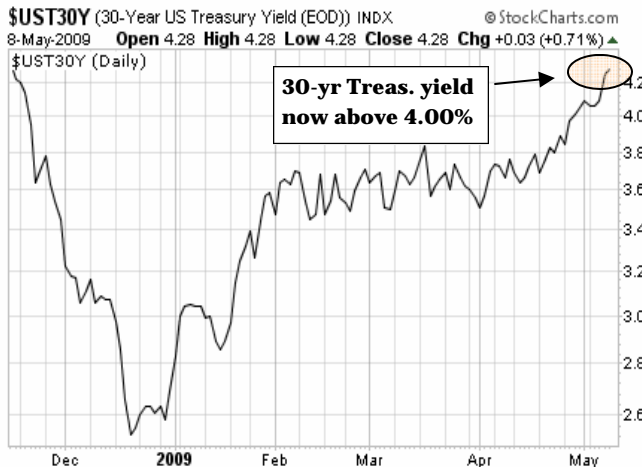
3. **Inflation risk** – as the Fed increases the money supply to monetize U.S. debt, investors are becoming more concerned about the spillover effects in the real economy leading to higher prices for imported goods and consumer staples such as food and energy.

Of major importance to the U.S. economy and the AFCG investment strategy, is the fact that China has made it clear that they will not be buying as much of our debt for the factors stated above. In lieu of using their growing hoard of almost \$2 trillion in foreign exchange reserves to help fund our deficits, they are actively diversifying out of the dollar (and dollar-denominated debt) by purchasing natural resources such as gold, copper, oil, and other strategic commodities - including majority stakes in key commodity producing companies around the globe.

All of these underlying economic interactions with China come at a critical time when the U.S. government, according to new White House budget estimates as of May 11, must now borrow an estimated 46 cents for every dollar it spends in 2009 and 35 cents in 2010. These events are creating what amounts to a "perfect storm" for a national funding crisis. This should continue to have increasingly adverse effects on the global markets - and the benchmark U.S. Treasury bond market, in particular.

Because of the dynamics we see unfolding in the global markets, our general outlook for 2009 remains the following:

1. **Interest rates should continue to rise** over the intermediate term. Since the December low, the interest rate on the 30-year U.S. Treasury bond has already risen by almost **70%**. See chart below.



2. **The U.S. dollar should decline** in purchasing power vs. hard assets such as food and energy.

3. **The broad stock market will experience fundamental headwinds** from rising interest rates, declining corporate earnings, and negative investor sentiment causing P/E multiples to eventually contract.

4. **Potential further wide-scale exodus** from riskier paper assets like longer term U.S. debt securities into natural resources and other hard assets such as gold/silver for inflation protection.

5. **Declining real estate values** due to another very problematic wave of mortgage re-sets in Prime, Alt-A, and Option-ARM categories from 2009-2011.

In light of these fundamental factors, we are emphasizing the following investment themes in our model portfolios:

1. **Holding cash** in short-term Treasuries for capital preservation and liquidity.

2. **Waiting patiently** for lower valuations and buying opportunities in stocks and bonds ahead.

3. **Buying stock funds** in select natural resource sectors.

4. **Building a core position** in a gold/silver bullion fund for portfolio insurance due to heightened systemic risks.

5. **Utilizing inverse funds** designed to profit from falling prices in overvalued sectors like long-term bonds.

6. **Increasing exposure** to agricultural commodities, oil, and other tangible natural resources on price dips.

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chain—only a notch below the IRS), were forced/threatened/coerced by the current administration to *give up their rights as secured creditors* and accept less than they otherwise would have gotten under the bankruptcy laws which govern these types of events. This same scenario looks likely to play out with General Motors and its bondholders.

Example #2: Under the previous administration, the heads of the largest U.S. financial institutions were summoned to Washington to meet with then Treasury Secretary Henry Paulson. Each of these CEOs was forced to sign an agreement to accept financial “assistance” from the federal government – without the option to decline. The official rationale behind requiring all to accept the money was to avoid stigmatizing the banks that really needed the bailout. Instead, they left investors and depositors guessing which ones were really sick.

Ostensibly, the just-completed bank “stress tests” were to

provide an objective evaluation of who is healthy and who is not. Alas, as any parent knows, it’s exceedingly hard to be objective about one’s children. Publicly finding fault with one, particularly when it could lead to the child’s failure, is hard for even the most stoic of parents. Make no mistake, these banks are the legitimate offspring of the Federal Reserve – that same “parent” charged with regulating them for the public good. It is unlikely this latest report card on Junior and his siblings can be...taken to the bank.

To put it succinctly, the “not so invisible hand” of government meddling in every aspect of corporate governance, capital formation and deployment, combined with an opaque regulatory regime (the Fed and Treasury), might ultimately drive capital formation out of the U.S. to other jurisdictions where they “treat money better.” If you change the rules in the middle of the game, no one is going to want to play. In fact, our playmates from China may already be packing up their marbles....

Sources:

1. *Bloomberg.com*
2. *Stockcharts.com*
3. *Thompson Reuters*

ATWILL FINANCIAL CONSULTING GROUP, LLC is a fee-only investment advisory firm located in Richmond, Virginia. Our investment professionals, serving in a fiduciary capacity, provide investment management, financial planning, and other advisory services to our clients.

Our Services

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- ◆ Qualified Retirement Plans
- ◆ Custom Consulting Services

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