



ATWILL FINANCIAL  
CONSULTING GROUP, LLC  
A Registered Investment Advisor



# Quarterly Observations

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## Q3 2011 Review and Commentary

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***“Gold, unlike all other commodities, is a currency...And the major thrust in the demand for gold is not for jewelry. It’s not for anything other than an escape from what is perceived to be a fiat money system, paper money, that seems to be deteriorating.”*** - Alan Greenspan, Ph.D., former Federal Reserve Chairman, August 23, 2011

### Bedrock

#### *Seeking Real Value in a Transitory World*

**Charles B. Atwill, CFP®**

IN A WORLD WHERE AN EARTHQUAKE CAN MOVE the entire island of Honshu (Japan’s main island) by an estimated 2.4 meters (almost eight feet), the term “bedrock” as a standard of permanence and immovability might ring hollow. The earthquake and tsunami that ravaged coastal Japan in March – quite literally – broke the geological moorings that tethered a country to the planet on which it resides. While the separation of landmass from planet was relatively brief, the destruction of large swathes of the coastline defies words. Tectonic forces like the ones involved in the Fukushima earthquake can shake the very notion that anything of this world is, indeed, permanent.

As financial markets convulsed through much of the last two months, it was easy to question where exactly one could find safety amid the chaos. Few asset classes – outside of the US dollar and Treasury bonds – afforded much protection from the volatility. However, times like these can inspire one to think about what is valuable in an absolute sense, and what might be cast asunder in the violent forces of a financial tsunami.

In a “margin call” event such as the one we experienced last quarter, cash is king. During these events, big market participants (e.g., “hedge funds”), trading with massive amounts of leverage (i.e., “borrowed money”), may be forced to raise cash (**see page 2 for an example of leverage**). When a hedge fund borrows money to invest, it is required to maintain a minimum amount of collateral to

satisfy the lenders. If this requirement is not met at some point, a margin call ensues. At that point, the hedge fund must sell anything it can – at any price – to raise cash to meet the margin requirements. The result: many good, *valuable* assets are sold off indiscriminately and prices on them fall until buyers return. When this happens, the market price of an asset disconnects from its intrinsic value.

Paradoxically, while cash (paper money) is the “safe haven” position *sine pari* during a rout, it is simultaneously dangerous to hold as a long-term position because of the ease with which it is being devalued by governments. Before modern central banking and the advent of multi-trillion dollar deficits, the effects of price inflation were, generally speaking, negligible. With central banks printing electronic money by the trillions and back-stopping entire sectors of the economy (not to mention entire countries at this point) paper currencies have lost much of their appeal as “safe havens” to store purchasing power over time. Once considered bedrock, cash is now more akin to quicksand, slowly devouring the holder until all purchasing power has been consumed.

AFCG’s foundational investment classes continue to be precious metals, natural resources, and income-producing securities issued by financially strong entities. We are under no illusion that our investments are immune from shorter term periods of sharp volatility. Instead, we look to our investments as the bedrock of portfolios required to withstand the punishing circumstances of the global debt crisis, as well as the arduous test of time.

The debt crisis has increased near-term volatility in the financial markets while making the case for owning assets of real value (gold/silver, food, energy, etc.) even stronger.

**Leverage in Financial Markets “101”**

**Charles B. Atwill, CFP®**

At its most basic level, *financial leverage* is a way to use less of one’s own money to accomplish a specific investment goal. A common example of this strategy is the good old-fashioned home mortgage: you want to buy a \$100,000 house—but have only \$10,000 in your bank account. You borrow \$90,000 from the bank (in the form of a home mortgage), and voila, you buy the house—financed with *leverage*.

Now let’s say you are a hedge fund (generally, a limited partnership that pools investor money with “borrowed” money). For the sake of simplicity, let’s say you have \$10,000 in your fund, but want to buy \$100,000 worth of Apple, Inc. common stock. You might borrow \$90,000 from your *prime broker* (the firm that executes your trades and has custody of your investment assets), combine it with your \$10,000 and, congratulations, you can buy \$100,000 of Apple!

Now, this may seem like a ridiculously easy way to make a lot of money—right? Prices always go up—right? Well, welcome to the world of the dark side of leveraged investing, the MARGIN CALL. For the sake of mathematical simplicity, let’s say your

If you can keep your head when all about you are losing theirs...

*Rudyard Kipling*

“If”

Apple stock falls by 25% in value. Your *prime broker* gets nervous that the money he has loaned you may not be repaid if the stock keeps going lower. You get a phone call: “we need an additional \$15,000 in your account by close of business today—or we’re liquidating your position in Apple.” You look at your business partners sheepishly: “does anyone have an extra fifteen grand lying around?” Heads shake, no.

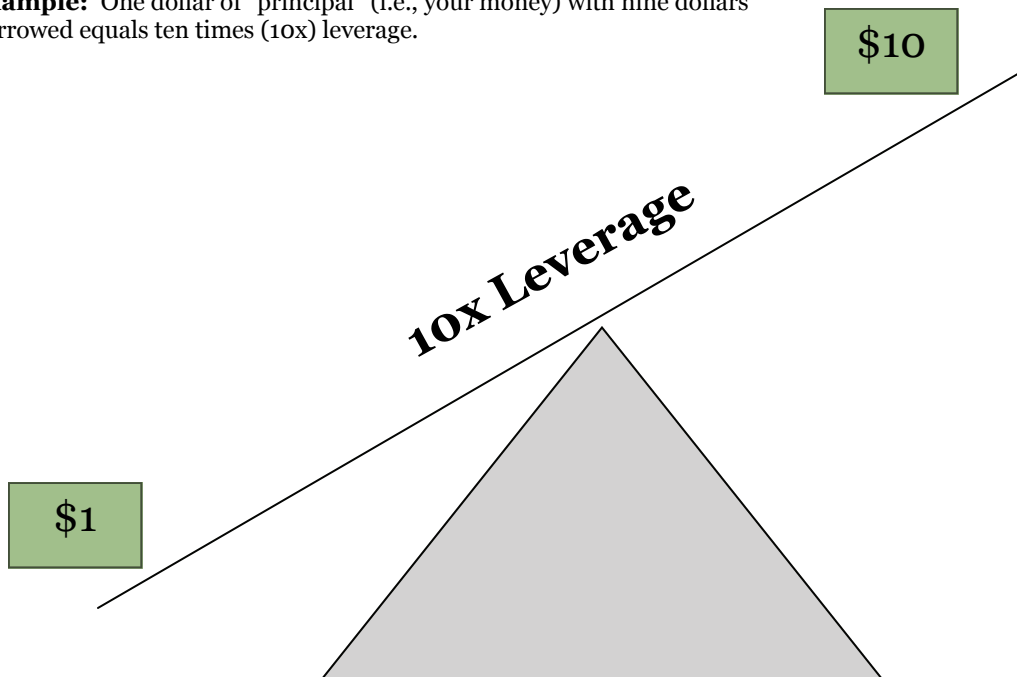
Now, the interesting part. You, and many other investment managers in the world that own a leveraged position in Apple, all go to sell 15% of your investment -- at the same time. The stock falls further, thousands of more margin calls go out all over the world. Wash, rinse, repeat. At some point the selling abates, and investors with cash see enormous value in the temporary carnage. As these buyers come in, prices stabilize -- the cycle is complete and value eventually trumps price.

The exact figures relating to margin requirements and amounts of systemic leverage are not nearly as important as understanding *why* markets can occasionally go into free-fall. Relating this to our comments in *Bedrock* on page 1, the current *price* of an asset may not necessarily reflect its true *value*. While it’s not an enjoyable experience, temporary price declines in good investments do occur. Understanding the *reasons* and *context* for periodic volatility is critical to a sound investment strategy.

Give me a lever long enough and a fulcrum on which to place it, and I shall move the world.

-Archimedes

**Example:** One dollar of “principal” (i.e., your money) with nine dollars borrowed equals ten times (10x) leverage.



**AFCG Absolute Return Models October 2011**

Target Allocation by Asset Class

| Asset Class           |                          | Global Growth | Global Growth & Income | Global Income & Growth | Global Income |
|-----------------------|--------------------------|---------------|------------------------|------------------------|---------------|
| Growth & Total Return | Equities                 | 78%           | 36%                    | 24%                    | 12%           |
|                       | Global Allocation Funds  | 0%            | 22%                    | 24%                    | 30%           |
|                       | World Bonds              | 0%            | 20%                    | 24%                    | 30%           |
|                       | Cash/Cash Equivalents    | 2%            | 2%                     | 8%                     | 8%            |
| Precious Metals       | Gold/Silver Bullion Fund | 20%           | 20%                    | 20%                    | 20%           |
| <b>Total</b>          |                          | <b>100%</b>   | <b>100%</b>            | <b>100%</b>            | <b>100%</b>   |

**Economic and Capital Markets Outlook**

**Justin D. Harris, AAMS®**

A NUMBER OF SIGNIFICANT ECONOMIC events occurred this past quarter which we will review and attempt to put into meaningful context. As we write, ongoing global financial issues include the following:

- the serious threat of sovereign debt defaults originating in the periphery of the Eurozone from Portugal, Italy, Ireland, Greece, and Spain;
- a bumbling policy response so far from European leaders and the European Central Bank (ECB) to remove the near-term potential for cascading sovereign debt defaults and major bank failures has increased financial stress levels throughout Europe’s banking system and global financial markets;
- Europe’s undercapitalized banks are intimately connected to their “too big to fail” bank counterparts in the U.S. through the plumbing of the “Shadow Banking System” -- a multi-trillion dollar web of debt, over-the-counter derivatives, and off-balance sheet activities/entities. This also includes the U.S. money market system loaded with several hundred billion dollars of short-term European bank debt (hence the contagion effect);
- for the first time in history going back to 1917, Standard & Poor’s downgraded the U.S. credit rating by one notch from AAA to AA+ on August 6, while keeping its rating outlook “negative” in the aftermath of the summer political circus over the U.S. budget crisis;

- at its September meeting, the U.S. Federal Reserve Board announced “Operation Twist”. In layman’s terms, “Operation Twist” is a nonsensical \$400 billion central bank policy crafted to further distort interest rates by suppressing long-term rates (6-30 years) relative to short-term rates (0-3 years); and
- the U.S. Federal Reserve Board also reaffirmed that it would continue to i) reinvest proceeds from maturing mortgage-backed securities it owns into other mortgage-backed securities and ii) hold its federal fund target interest rate between 0% - 0.25% at least through mid-2013 due to U.S. economic weakness and high unemployment.

**Key Points:** Responsible savers continue to get penalized by a rising cost of living and negligible interest rates while investors seeking growth, income, and inflation protection continue to experience sharp, near-term volatility.

Global financial markets for stocks, bonds, currencies, commodities, and precious metals, are convulsing in response to the overarching debt predicament facing the U.S. and Europe.

Market participants are also dealing with uncertainty surrounding the timing of the next round of massive liquidity injections needed to kick the debt crisis can a little farther down the road into 2012.

At this time, markets are trading around two data points:

*(Continued on page 4)*

# Economic and Capital Markets Outlook *(continued)*

*(Continued from page 3)*

1. The need for a large-scale recapitalization (read: “bailout”) of major European banks along with some form of orderly debt default by Greece; and
2. The prospect of the U.S. Federal Reserve formally initiating another round of quantitative easing (read: “money-printing”) to monetize debts, stabilize things on our side of the Atlantic, and pump more dollar liquidity into the financial markets and banks. Markets were hoping for this policy announcement (which did not occur) at the Fed’s September meeting. **This policy delay combined with an increase in margin requirements by the CME for certain gold, silver, and copper futures contracts roiled financial markets in the last two weeks of September setting off a large wave of forced selling.**

One needs to take a look at only a chart of the benchmark KBW Bank Index (an index of 24 large U.S. banking companies including Bank of America, Citigroup, Wells Fargo, JP Morgan Chase & Co., Bank of New York Mellon, etc.) **down 28% year-to-date as of October 13** to sense the growing concern at the Federal Reserve and in Congress:



**Our Assessment:** We believe it is only a matter of time before both the ECB and the Federal Reserve respond to recent financial market weakness and the sovereign debt default threat by announcing Quantitative Easing Part 3 (“QE3”) to pump trillions in new currency units (dollars and euros) into the banking system of developed Western nations.

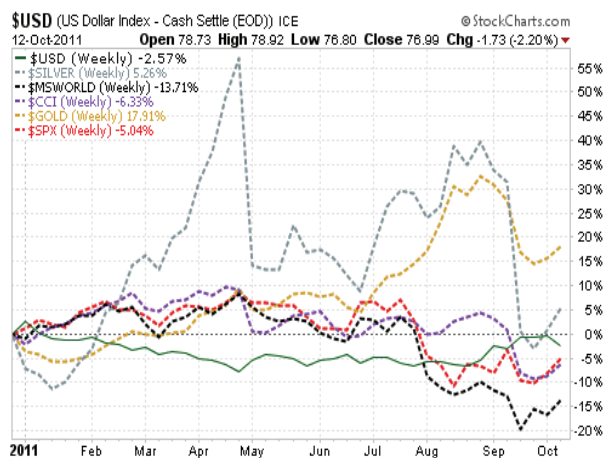
We expect volatility across global asset classes and financial markets to remain elevated until such accommodative monetary policies are announced. We anticipate that such policies will cause commodity prices to bottom and reverse to reflect global demand for limited supplies of agriculture, metals, and energy resources.

## A Bull Market in Sound Money

It is not every day that one of the world’s major currency regimes verges on disintegration. Unfortunately, the Eurozone appears to have reached this critical point in time. How this major issue is addressed from a monetary policy and political standpoint among the culturally disparate 17 member nations using the euro as their currency should continue to dominate the global financial markets in the coming weeks and months.

To provide a perspective of the global debt crisis and the effects on financial markets year-to-date, we include a chart below of relevant benchmarks **as of October 12:**

| <u>Chart Symbol</u>                | <u>Return (1/1/11 - 10/12/11)</u> |
|------------------------------------|-----------------------------------|
| U.S. Dollar Index (\$USD)          | - 2.57%                           |
| Silver (\$SILVER)                  | + 5.26%                           |
| MSCI World (ex USA) Stock Index    | - 13.71%                          |
| Continuous Commodity Index (\$CCI) | - 6.33%                           |
| Gold (\$GOLD)                      | + 17.91%                          |
| S&P 500 Large Cap U.S. Stock Index | - 5.04%                           |



The 10-year gold chart that follows (**see page 5**) helps to put gold’s recent price correction from over \$1,900 per ounce down to the \$1,650 range into context.

As we have been writing about since 2008, gold as an asset class continues to resume its historical dual role as sound money and the ultimate safety asset for global investors seeking insurance from counter-party risk.

Despite the volatility, we continue to hold and accumulate gold and silver related investments (including bullion funds and mining stocks) for these primary reasons.

*(Continued on page 5)*

# Economic and Capital Markets Outlook (continued)

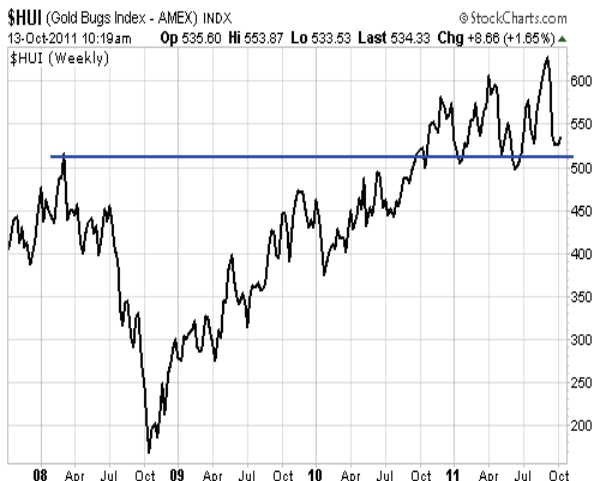
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Our view is that gold's recent volatility is shorter term in nature and unrelated to any change in fundamentals that support higher gold and silver prices ahead. Gold's recent correction has taken the price down towards its **40-week moving average** (the red line). Gold's longer term uptrend remains intact:



The next chart of the NYSE Arca Gold Stock Index (HUI) shows how major gold mining stocks have not yet followed gold and silver bullion prices higher.

Due to recent selling in gold stocks with the general stock market, gold stocks are now trading at the same level as they were in 2008 when gold prices were \$1,000 per ounce and silver prices were \$20 per ounce.



By comparison, gold and silver prices are 60% higher in 2011. We believe this valuation disconnect makes gold and silver mining stocks very undervalued relative to earnings and cash flow these companies will be generating in the quarters ahead. Also, we believe the same valuation disconnect currently applies to energy stocks.

## China and Natural Resources Update

The global energy sector has also experienced a sharp correction this past quarter, which we attribute to two shorter term, non-fundamental factors:

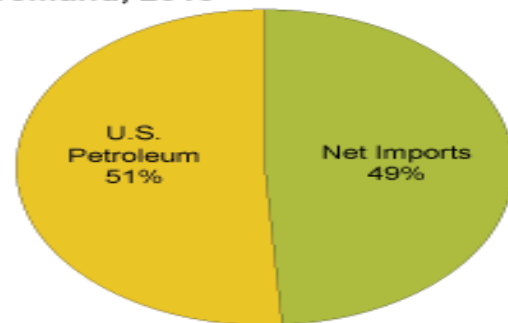
1. There has been indiscriminate selling related to margin calls and a rush for liquidity by large shareholders of oil, natural gas, coal, and energy services stocks. Stocks are being sold to meet redemptions.
2. As world economic growth projections are reduced, global oil demand estimates have been reduced slightly. The fundamental factor that market participants are not focusing on right now is the fact that global oil supplies are averaging around 88 million barrels per day and global oil demand is averaging around 89 million barrels per day.

In other words, we believe the recent sell-off in energy stocks belies entrenched global supply/demand imbalances looking out over the months and years ahead. Quality energy stocks are now very undervalued. We continue to hold and accumulate energy sector investments in client accounts as appropriate.

The fundamental facts regarding the global oil market remain the following:

- The U.S. imports around 50% of its daily oil need:

**Net Imports and Domestic Petroleum as Shares of U.S. Demand, 2010**



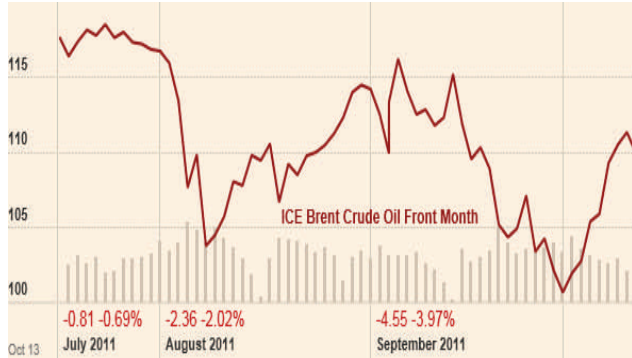
Source: U.S. Energy Information Administration, Monthly Energy Review, Table 3.3a (April 2011), preliminary data.

- China is now the world's largest energy consumer and imports 55% of its daily oil consumption need;
- Two-thirds of the world's remaining oil reserves are located in the Middle East and Africa, two highly unstable regions where never-ending wars and conflicts are being waged; and

(Continued on page 6)

(Continued from page 5)

- Brent crude -- the benchmark that two-thirds of international oil production is priced off of -- has disconnected from West Texas Intermediate crude (the U.S. benchmark). Brent crude now trades over \$110 per barrel while WTI crude trades at \$84 per barrel:



Why is the \$25 premium in Brent crude over WTI crude important? It confirms that growing oil demand pressures are primarily coming from the non-OECD (Emerging Market) countries like China and India and that global supply/demand imbalances are still supporting a \$110 per barrel oil price despite sharp corrections in the U.S. oil market. This shorter term phenomenon in the U.S. oil market supports our assessment that energy stocks are fundamentally undervalued and should trade higher in the periods ahead.

**AFCG’s Investment Strategy**

After a very volatile third quarter and a rapid escalation of economic problems affecting Europe and the global banking system, we conclude our *Quarterly Observations* with the following comments for our clients who have generously placed their trust in us:

- Large, multi-national banks and several sovereign nations are on the verge of insolvency and debt defaults;
- When push comes to shove, we believe that politicians and/or central banks will act to bail out the global financial system once again -- this would be a continuation of the inflationary debt default process that central banks have been engineering since 2008;
- A key part of the inflationary default process is to keep interest rates artificially low (making U.S. treasury bonds *overvalued*), which the Federal Reserve has been successful in doing so far; and
- Assets classes with inherent worth -- agriculture, energy, gold/silver, critical technology metals, and income-oriented securities issued by financially responsible corporations and countries should continue to pay interest/dividends and increase in value over time.

We are available at any time to discuss ongoing market events and provide real-time economic updates as needed. The global debt crisis has not been solved and owning sound money (gold/silver) remains a core part of our strategy.

**Sources:**

1. Bloomberg ([www.bloomberg.com](http://www.bloomberg.com))
2. StockCharts ([www.stockcharts.com](http://www.stockcharts.com))
3. U.S. Energy Information Administration ([www.eia.gov](http://www.eia.gov))

4. Financial Times ([www.ft.com](http://www.ft.com))

ATWILL FINANCIAL CONSULTING GROUP, LLC (AFCG) is a fee-only investment advisory firm located in Richmond, Virginia. Our investment professionals serve in a fiduciary capacity to provide clients with financial planning, investment management, and financial consulting services fully coordinated with each client’s CPA, insurance professional, and estate planning attorney.

**Our Services**

- ◆ Investment Management
- ◆ Modular Financial Planning
- ◆ Total Wealth Planning (TWP™)
- ◆ Financial Consulting

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