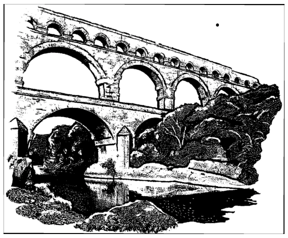
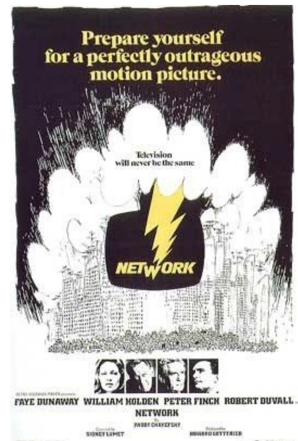
Stanley E. Rulapaugh, CFA **April 1, 2010**



"... at the bottom of all our terrified souls we know that democracy is a dying giant, a sick, sick, dying, decaying political concept writhing in its final pain. I don't mean that the United States is finished as a world power. The United States is the richest, the most powerful, the most advanced country in the world, light years ahead of any other country. And I don't mean the Communists are going to take over the world because the communists are as dead as we are. What is finished is the idea that this great country is dedicated to the freedom and flourishing of every individual in it. It is the individual who is finished. It is the single, solitary human being that is finished."

Transcript of speech by Howard Beale, character in the movie *NETWORK*

I'm tired of the political feuding in Washington and doubt there is a single unwritten or unspoken defense or criticism of the so-called "health care" legislation. Therefore, this quarterly note includes bits of information I find interesting and that you may have missed. Enough of health care, already!



The quote that starts this letter was written by Paddy Chayefsky for the character Howard Beale, a fictional newscaster on the UBS network. Howard's ratings are declining and he is given his two-week notice. He is a bit unhinged and tells his audience he will kill himself on TV. Ratings soar and the network races to take advantage. I bring this up because "Network" is a window on today's Tea Party movement. Howard Beale's most famous quote, which he urges all his watchers to yell out their windows is, "I'm mad as hell and I'm not going to take it any more." The movie is playing now and then on TCM. You can watch the key scene in this 1976 movie at this link. Type it in your internet browser.

http://www.tcm.com/video/videoPlayer/?cid=294074&titleId=342

NETWORK is thirty-five years old and the grievances seem to be the same as today. You will recall that Richard Nixon resigned from office in August 1973, leaving the job to Gerald Ford. The public didn't much like Ford and the memory of Nixon so elected Jimmy Carter in 1976. Carter was seen as a breath of fresh air, just the change we needed during the very period that Howard Beale is ranting about. We did get change, but not what anyone expected. Carter is best known for high inflation and the Iranian hostage crisis. Carter proved to be as worthless as they come. His only "accomplishments" seem to be the creation of the Department of Energy and the Department of Education. Are our kids better educated? Are we energy independent? Neither of Carter's creations did much more than expand the Federal bureaucracy.

The popular media dismisses the Tea Party movement as a bunch of right wing loonies. The derision does not square with the evidence. Since Obama's inauguration, the TV viewing habits of the country have changed. The latest ratings show the Fox News Channel as the second highest rated cable channel on all of television during the first three months of 2010. Lovers of CNN and MSNBC will be stunned to learn they were 17th and 24th respectively during the same period and that Fox had more viewers than CNN and MSNBC *combined*. The much-maligned Fox had nine of the top ten programs on cable news in terms of total viewers.

As I watched Howard Beale in the movie, I was instantly reminded of Glenn Beck on Fox. Beale may have been nuts but people watched. Beck's detractors dismiss him as a clown but his program is the fastest growing show in cable news. The Obama administration promised "change" but I don't believe Glenn Beck's popularity was the kind of change it expected.

The Administration is making a very big deal about "financial regulation" and the fact that bankers, brokers and advisers are, by their very nature, crooks. I have written in prior letters that regulation does not by itself prevent crookery. Nor does it seem to deter crookery. Bernie Madoff's company is a great example of a large, highly regulated investment adviser. Yes, Bernie was regulated but not supervised. Here is another example of a lack of supervision.

> **January 11, 2010 (InvestmentNews): Brokerage hit with triple damages in 95-year-old's arbitration award**
> . . .panel awarded the elderly investor, David Wolfson, $1.6 million . . . According to the complaint, [the brokers] "encouraged and invited Mr. Wolfson to leverage the equity in his home with a reverse-mortgage transaction to utilize as investment capital." . . . Mr. Wolfson had been a client . . . for almost 20 years, until the broker dropped the account in 2008.

> A footnote to the lawsuit alleged that [the broker] quit because he had bilked nearly all of Mr. Wolfson's assets - including the equity in his home, all his cash reserves, all his emergency/medical cash reserves and even the insurance money Mr. Wolfson received to replace his automobile - and there was nothing left to churn.

I think this would be a tough case for a defense attorney.

Under the current regulatory regime, advisers can expect a visit from the Securities and Exchange Commission once every five to ten years. There are firms that have been in business for more than five years that have not had one visit from the SEC. Like most government agencies, the SEC is underfunded and understaffed. A few years ago, the SEC made the individual states responsible for smaller advisers. The definition of "smaller" is about to grow with SEC threats of making every adviser with assets under management of $50 million wards of the states. The states don't have any money so I doubt they would welcome an additional unfunded mandate from the Feds. Supervision and oversight will fall farther behind and, in a few more years, we will hear calls for stronger regulation when, once again, the evidence will be clear that the regulators aren't capable of doing the job.

On March 20, 2010, *The Arizona Republic* published an article about a "shadow inventory" of houses that could precipitate another decline in prices this year. Thousands of houses are held in "weak hands," owners waiting for just the right time to get rid of their inventory. These include bank-owned properties created by foreclosures or those about to be foreclosed, abandoned homes, and speculations held by flippers who bought a few months ago and want to make a quick buck. Citizens hoping for an early end to the housing bust are going to be disappointed. My favorite quote, used here before, is from Gottfried Haberler's book, <u>Prosperity and Depression.</u>

> A machine or a house cannot be made to give up all its services in a short time, even if its price (or the price of its services) is reduced to zero. Sales of machines or houses can, of course, be hastened by lowering their price. But that does not eliminate them; they are still there, and their very existence restricts the demand for similar goods. It is only by selling them and using them up for scrap that they can be eliminated outright. But this could only happen when their price had fallen so low that reproduction, not to speak of adding to capacity, was out of the question.

A house appraised at zero is still worth something as a rental. And an influx of new rentals from the shadow inventory will drive down the price of existing rentals. I heard at a convention not too long ago that a house is worth only "fifteen times the annual rent." Where that came from I have no idea but I suspect there is a historical relationship somewhere. Anyway, during the boom, houses in my neighborhood rented for $2,000 a month, $24,000 a year. That put values somewhere around $360,000. Owners wanted $550,000 and up and got it. Some sold for $600,000. Big buyer mistake.

How much would your own home bring as a rental? Make the same calculation shown above to estimate your own home's worth. This will give you some idea of your downside risk.

During the last two years I tried not to invest in bonds. My main concern was, and is, the prospect of inflation in the next few years. My bond issuer of choice was the U. S. Treasury. Because of the perceived safety of Treasuries, they were the benchmark against which all other securities were measured. I use the past tense because the safety of Treasuries is being questioned now that the Bush/Obama deficits don't seem to have an end. In February, Warren Buffet's Berkshire Hathaway sold two-year notes with an interest rate that was <u>lower</u> than a comparable Treasury issue. In investment terms, that meant that Berkshire was less risky than the Treasury. The same statement can be made for Procter & Gamble and Johnson & Johnson which are seen as safer bets than the government. Personally, I would rather own a bond issued by an entity that exhibits some fiscal discipline than one that doesn't. And what is bothersome is that no one in the current administration seems concerned about the declining quality of government-backed bonds or the standing of our bonds in world markets. Never forget. It's not about the return <u>on</u> your money. It is about the return <u>of</u> your money.

There are two ways to get out of our debt hole: tax or inflate. So far, taxing is favored. Inflation comes later. Rather than bonds, I prefer stocks of companies that earn their way, grow from internally generated funds and have the ability to pay me a dividend. I want to be an owner and not a lender.