

GREY INVESTMENTS

“2010 – Time to Play Defense”

We typically take a family cruise at year end during which I take the time to do something I haven't been able to do since college, which is browse through a library and try to read a book a day on any subject of interest. I read a few books on the brain and or psychology but didn't find much there to help us make money. This year our ship had an extensive business library and I took the time to read a few and think about what the future holds for our investments. “When Markets Collide” by Mohamed El-Erian (former head of Harvard's endowment and now running Pimco, the largest bond manager in the world) argued that the rise of nations that formerly were debtor nations with little systemic influence must be given much more weight when making both equity and bond investment decisions. “The Black Swan” by Nassim Nicholas Taleb argues that models that attempt to forecast economic events are inherently flawed as they fail to take into account what he characterizes as “unknown unknowns”. Taleb notes that events that should theoretically occur every 100 years (the 22% one day crash in 1987, 9/11, the crash precipitated by Lehman Brothers 2008 failure) happen so often because we fail to acknowledge that there are unknown unknowns that can't be modeled.

Finally, “The Great Depression Ahead” by Harry Dent Jr. argues that there are economic cycles driven by demographic trends and as baby boomers age our reduced spending will lead to a worse crash than we experienced in 2008. Dent also argues that this crash will be made worse by a continued slide in real estate prices as trends for prices to outstrip inflation and building costs will revert back to the mean. Let's look at what happened last year with your money and talk about how the foregoing may shape our investment allocations going forward.

Our investment models performed exceptionally well during 2009. Our moderate risk portfolio is based on an allocation of 50% equities, 50% bonds and returned 22.8% for 2009. This recouped the losses from 2008 on a percentage basis. Our conservative model (30% stocks) did even better as the 2009 return of 16.5% substantially exceeded the 2008 loss of 11.78%.

1. On the equity side, our allocation to emerging markets (Brazil, India and China) was very profitable with gains exceeding 75% in 2009;
2. Vehicles providing exposure to stocks of international developed markets (Western Europe, Japan) gained over 28% and the U. S. markets vehicle also up over 28% helped returns;
3. Our investment work with Professor Simon has paid dividends, as our asset allocation for bonds substantially outperformed the Barclays Aggregate Bond Index which gained 5.93%. For example, the vehicle used for intermediate term corporate bonds advanced 17.88% for 2009 and our municipal bonds vehicle gained over 13% while not even including the benefits from the tax sheltered income;

4. Eliminating Treasury notes and bonds from our model worked well as the vehicle we use to track this asset lost 1.7% in value;
5. Eliminating our allocation to gold at approximately the \$750 level has not worked well as gold continued to move higher on inflation speculation and general uncertainty.

While I don't particularly like sports metaphors I think nothing can be clearer than saying that if 2009 was a time to stay fully invested and play offense, 2010 is a good time to play defense. By that I mean our investment committee will spend most of our time strategizing as to what may go wrong and making sure your portfolio is positioned to handle what we think may be a difficult 2010. Our general thoughts on the 2010 investing climate are;

1. Although I remember little of what I learned in the mid-70's as I got my economics degree, I do remember the confusing method for calculating unemployment statistics whereby people who were so discouraged they gave up job-hunting or took jobs that didn't utilize their skills were not included in the unemployment numbers. The current broader measure of unemployment including these folks approximates 17%, much higher than the 10% number our government emphasizes. The level of unemployment poses a significant threat to our recovery;
2. Conventional wisdom is the stimulus programs have jump-started the economy sufficiently so that GDP growth rate will resume at previous levels as stimulus wears off. It is difficult to tell where GDP growth will be once it resumes, but we are concerned that lower rates of growth or a reversion to negative growth are quite possible, and more stimulus will weaken our credit rating;
3. We believe the residential real estate market has not seen a bottom in prices; the Wall Street Journal reported recently that 25% of homeowners are underwater on their homes, that is mortgage debt exceeds value. Falling home values and weakened consumer spending elevates the risk GDP could fall back to the negative;
4. The willingness of both political parties to ramp up spending quicker than revenue cannot continue indefinitely and has already weakened our financial strength. Moody's created some quickly forgotten headlines when it maintained a AAA rating on the debt of the U.S., but downgraded the U.S. rating within the AAA band. Moody's characterizes the U.S. as a country "whose public finances are deteriorating considerably". It may shock you to know that Moody's ranks our financial strength on par with the United Kingdom and weaker than that of either France or Germany!
5. The Fed has injected record amounts of liquidity into our financial system: their balance sheet is over \$2 trillion dollars and short term interest rates are close to 0%. Unwinding this stimulus is fraught with risk, too slow could cause inflation to take hold, withdrawing too fast could sink us back to negative GDP. Fixed income returns may be quite low for 2010.

Playing defense doesn't mean we advocate putting your money under a mattress! We feel the highest probable outcomes dictate the following investment strategies/tactics;

1. We can assume with a high degree of confidence that no politician, Democrat or Republican will cut spending and the threat of losing our AAA credit rating will result in substantially higher tax rates. Notwithstanding the weakened position of some states, this makes AMT free municipal bonds the best single risk/reward investment;
2. While interest rates should remain low for 2010 we are shortening the maturities of bond portfolios in anticipation of interest rates eventually trending higher;
3. We believe the U.S. dollar is vulnerable and are reviewing the "best in class" vehicles for adding foreign bonds as an asset category to provide more exposure to foreign currencies;
4. Although inflation is not an immediate threat we prefer a small allocation to oil prices in addition to TIP's to allow for an unexpected surge in prices;
5. As the U.S. share of world GDP shrinks we are increasing our exposure to foreign stocks at the expense of U.S. stocks.

We have provided below the performance of our investment models.

Investment Model, Percentage Returns		2008	2009
Conservative	(30% Stocks)	-11.8	+16.5
Moderate	(50% Stocks)	-22.6	+22.8
Aggressive	(70% Stocks)	-29.9	+27.8

Benchmarks		
Barclays Bond Index	+5.2	+5.9
S&P 500 Index	-37.0	+26.4

NOTE: It is not possible to invest directly into a model. Models have no expenses or investment fees; actual investment performance may be different.