



BOYER & CORPORON
WEALTH MANAGEMENT, LLC

Investment Commentary May 1, 2009

I just returned from the annual CFA Conference which was held at a Disney resort in Orlando. It was an incredible 3 days. The conference was attended by Financial Analysts from all over the world. Last year it was held in Vancouver and the next two conferences will be in Boston and Singapore. The 2008 conference is summarized in my June Investment Commentary, 2008.

The first speaker Sunday evening was Michael Lewis, author of "Liar's Poker", among other books. Liar's Poker is an entertaining exposé of the brokerage industry from the bond trading desk of Solomon Brothers. It was written 20 years ago and described the gluttony of Wall Street at that time, not realizing just how voracious Wall Street's appetite for money would eventually become. We were warned that his remarks were strictly for our group and everything he said was "off the record". Although his primary purpose for being there was to promote his new book, he had some entertaining as well as insightful things to say. His new book is about a man who saw the sub-prime mortgage disaster coming at an early stage and how he engineered a way to profit from it.



Monday morning the keynote speaker was Nouriel Roubini, Professor of Economics and

International Business at the Stern School of Business at New York University. If you want to remain optimistic....if you think things are going to get better soon.... If you don't want anyone to rain on your parade....then you do NOT want to be in the audience of Nouriel Roubini.

Roubini says we are in a "severe financial crisis". The only good news he could offer is that we avoided financial meltdown last fall. He quickly followed that up with the bad news – that conditions at U.S. financial institutions are severe and that many are already insolvent.

He predicts the U.S. will not experience a V-shaped recession (where the economy hits bottom and quickly bounces back) but will more likely experience a U-shaped recession (where the economy hits bottom and stays along the bottom for a while before trending higher). Additionally, he predicts 10% unemployment by this summer and 11% sometime in 2010.

Current consensus among most economists is that the U.S. will see positive signs that the recession is ending by the 4th quarter of this year. On the contrary, Roubini sees a decline of 2% in the 4th quarter and little or no growth for all of 2010.

Regarding the rest of the world, he said the notion that other high

growth economies (like China and some emerging markets) have “de-coupled” and would not be adversely affected by the recession in the U.S. is obviously incorrect. Most emerging markets are in a recession and China’s annual growth has slowed from 10% to 6%. Roubini describes it as a “Global Synchronized Recession”.

Interestingly enough, he doesn’t see inflation as an immediate threat. High unemployment removes the likelihood of wage increases. Excess capacity and excess inventories will lead to lower prices. He feels deflationary pressures could be with us for a long time.

Roubini says the financial system is broken and cannot be solved in six months. He feels that fiscal policy, as well as monetary policy, needs to remain aggressive in order to avoid zombie banks. He says that current policy is going in the right direction.

Regarding the stock market, he feels the rally that began March 9th is a “bear market rally” and he gave three reasons:

- His estimate for Q4 growth in the U.S. is -2% vs. the consensus estimate of +2%.
- Earnings surprises will be on the downside each quarter.
- There will be more financial shocks this year.

After an hour of Nouriel Roubini, we were ready for a different speaker. Next up was another author, Jim Stewart, who wrote “Den of Thieves” and “Disney Wars”. He spent a lot of time talking about the things he learned while writing Disney Wars. His presentation to us was titled “Corporate Governance”. Disney was a great example of a lack of Corporate Governance. He

described how the CEO of Disney, Michael Eisner, hired Michael Ovitz to be President of Disney with annual compensation of \$140 million....and then he got rid of Ovitz after a year. It has not been uncommon for executives of companies to walk away with hundreds of millions of dollars....AFTER FAILING! People who sit on the Boards of Directors of many companies are NOT acting in the interests of the owners of the companies (the shareholders). Mr. Stewart says that the traditional argument for excessive pay is that “we are in a competitive market for talent”. He says that argument never really gets tested....that a shareholder democracy has never really existed.



Michael Mauboussin, Chief Investment Strategist at Legg Mason Capital Management, gave a presentation on value Investing and why we tend to have a difficult time being successful at it. Human beings are inherently social beings and we frequently synchronize our behavior with other human beings. He described a well known psychological experiment conducted many years ago where eight students in a room were asked to compare three lines (A, B and C) to another line (X). In the experiment, the obvious answer was A. However, when seven of the students (who were confederates) answered C, the eighth student also answered C over 30% of the time. When enough people obviously think something is correct, it must be correct. Right?

The same phenomena takes place in the investment world. Although you might not have understood why oil traded as high as \$145 per bbl, the fact that enough people were willing to pay \$150 per bbl made people believe that there must have

been a rational reason oil traded for \$150 per bbl. Then, of course, a year later it is trading for close to \$50 per bbl.

The key to buying value stocks is having knowledge of the company's fundamentals and an expectation implied by the stock's price. The problem is sometimes we get caught up in the excitement ("If everyone is making money in technology stocks, then those stocks are obviously worth what people are paying for them").

It seems no matter how intelligent or logical we think we are, all of us have some degree of gullibility. All of us are capable of jumping on a bandwagon that appears to be a winning bandwagon. Stephen Greenspan wrote a book titled "Annals of Gullibility", a book with stories of gullibility related to religion, politics and finances. Ironically, It turns out Mr. Greenspan had money invested with Bernard Madoff (www.skeptic.com). You can be an expert on gullibility and still have your pocket picked.

The bottom line of Mr. Mauboussin's presentation is that the biggest obstacle in making rational investment decisions is us. The average person suffers more from the loss of a dollar than he/she enjoys the gain of a dollar. Furthermore, our behavior is different based upon how recently we suffered the loss. We tend to be more cautious if the loss was recent.



Peter Schiff, President and Chief Global Strategist of Euro Pacific Capital spoke Tuesday afternoon.... although I use the word "spoke" loosely. It was more like a 50 minute rant and he had to be interrupted by the moderator in order to have ten

minutes of Q&A. The first question during Q&A was, "Do you have ANY good news for the United States?" and he quickly responded, "No". That gives you an idea of the tone of his presentation. He made Nouriel Roubini seem like an optimist.

He believes there is no way to fix our current problems with fiscal stimulus and corporate bailouts....that belt tightening is going to be required by all, including the government.

Unlike Roubini, Mr. Schiff doesn't see deflation as a possibility. On the contrary, the rapid expansion of our money supply will lead to trillions of dollars chasing a smaller supply of goods resulting in massive inflation.

He says the next "bubble" in our financial system is U.S. Treasury Bonds. Massive purchases of Treasury Bonds by foreigners will not continue when they realize we are going to have difficulty paying them back. This will lead to a drop in the price of Treasury Bonds creating a spike in interest rates. Schiff says this will ultimately push the housing market and the U.S. economy "over a cliff".



And if you thought things couldn't get more dour than Peter Schiff, Whitney Tilson of T2 Partners, LLC gave us some extremely sobering statistics on housing and mortgages. In summary:

- Between 2000-2006, lending standards were loosened so much that a typical home purchaser could borrow triple the amount prior to that period.
- Americans have borrowed so much against their homes, the aggregate percentage of equity to debt has fallen below 50% for

the first time on record since 1945.

- As Wall Street was packaging these toxic mortgage securities to sell to unknowing investors, the profits of financial services companies grew to almost 45% of the profits of all companies profits (vs. 10% - 15% in the 70's and 80's).
- Nearly 8% of ALL mortgages were delinquent or in foreclosure at the end of 2008 (mortgages on 1- to 4- family homes).
- 24% of ALL homeowners today owe more on their mortgage than their home is worth today....30% of those purchased in the past 5 years are underwater.
- Although the period of "re-sets" and defaults for sub-prime mortgages is almost behind us, we still face 3-4 years of the same from "Alt-A" mortgages and "Option ARM" Mortgages. The amount of Alt-A and Option ARM mortgages issued is over \$3 trillion dollars and Mr. Tilson says virtually EVERY Option ARM mortgage will default. The good news is the Option ARM total only \$750 billion.

What is an Option ARM Mortgage? Option ARM mortgages were issued to high risk borrowers....borrowers with low credit scores that couldn't qualify for conventional mortgages. With an Option ARM Mortgage (ARM stands for Adjustable Rate Mortgage), the buyer does not have to make a down payment and borrows 100% of the purchase price of the home. Because the buyer is a "high risk" borrower, they have to pay a higher interest rate (maybe 8% instead of 5.5%). However, in order for such a borrower to be able to afford the monthly payment, they are required to pay a much lower interest rate for the first five years (as low as 2%). This was known as a "teaser rate". Actually they still get

charged 8% but the 6% they are not paying is added to their principal giving them "negative amortization". As if this is not enough to make their payment low enough so they can purchase the house, they also only have to pay interest for five years. With a normal mortgage the borrower must pay interest AND some principal. After five years elapses, the buyer's interest rate reverts to 8% AND they have to begin paying principal. This results in a monthly payment that can be more than double their original monthly payment. Since their house has declined in value, there is no way to re-finance and they are forced to default on the mortgage. If you are finding it difficult to believe that these mortgages were issued to anybody at all, remember:

- At the time these were issued, virtually everyone was operating under the assumption that property values would continue to increase like they had during our entire lives.
- Within five years, the homeowner would be able to refinance.
- The issuers of these mortgages were not taking the risk of default as they were quickly packaged together with other mortgages and sold to Wall Street.



From March 9th to the end of April, the Dow Jones Industrial Average and the S&P 500 have rallied 24.7% and 29% respectively. If Roubini is correct, the S&P 500 could decline as much as 40% in the next year. If he is half right, equities will still decline significantly from here. The housing statistics presented by Mr. Tilson lead us to believe that, even if Roubini is wrong about the equity markets, he is not going to be very wrong.

Our conclusions from the conference:

- We agree with Roubini that we are experiencing a global synchronized severe recession that is likely to get worse before it gets better.
- Deflation (or disinflation) will likely prevail for the next year or so but due to the massive issuance of new currency by the Fed and the administration, significantly higher inflation is almost inevitable.
- Whether we experience deflation or inflation, we anticipate higher yields on U.S. Treasury Bonds which will translate into higher rates for corporate bonds, municipal bonds and government agencies.
- Unemployment in April rose to 8.9% from 8.5% as another 600,000+ jobs were eliminated.
- New foreclosures in March increased to 341,000. The previous record was 303,000. If the presentation I saw on mortgages has merit, the next several years will not see a decline in foreclosures. If over one million households are forced to leave their homes every quarter, consumer demand will continue to suffer, unemployment will continue to rise and more people will have difficulty paying their bills. The Obama administration has committed funds to "modifying" mortgages but we are skeptical that modification will be effective. How can you modify a mortgage in which there was no down payment and the market value of the home is 20% below the mortgage balance? And will the homeowner even care? We think most people in this situation will make the easy financial decision....bankruptcy.

- Bankruptcy used to have a stigma associated with it. It represented financial failure. If you declared bankruptcy, you were in a very tiny minority that mismanaged your finances. Declaring that you are bankrupt today still carries a stigma but a decidedly less stigma. It is less difficult to justify an embarrassing financial situation when one is part of a rapidly growing population. If one becomes unemployed, the decision to default on the mortgage becomes a much simpler decision.



At Boyer & Corporon Wealth Management, we are taking advantage of the recent rally and reducing our equity positions even more. We feel there is more downside risk in the equity markets and very little upside return.

We continue to be concerned about rising interest rates and we are keeping our fixed income duration as short as possible while still earning a modest amount of interest.