

October 13, 2009

Some events are so enormous that history's judgment erects a permanent monument; something that remains long after all the eye witnesses are gone. Last Saturday, I boarded US Airways Flight 9092 to Washington, DC as part of the Triad's Flight of Honor to take 101 World War II Veterans to see such a monument, *their* monument: the World War II Memorial.

I was chosen to be one of thirty-six guardians, each of us assigned to accompany three of the Veterans (pictured, myself in red). Before the flight, knowing that seniors prize familiarity, I made an effort to both call and meet my 83, 86, and 91 year-old companions at the 'pre-flight' meeting. When the eldest couldn't make the meeting because he was under the weather, I drove out to his home. I learned how much the last ten years have demanded of him, but I got to hear a lot of happy memories too, and I could see that the more we talked, the better he felt. The only problem, I learned, was that the t-shirt he'd been given for the trip was an XXL but he needed an L at most. Before I could reel back in my words, I told him I'd take care of it.



After finding out there were no more shirts available, I called the seamstress who has repaired my dress shirts over the years. "Could you take a size XXL and make it into a size large?" I asked. "Sure," she said, in broken English, "You bring large t-shirt too when you come, ok? When you come?"



Ten minutes later, the owner of Alternation Studio, a petite Vietnamese woman and I were comparing a size L to the size XXL. The shirt had the Flight of Honor logo, which she asked about. "Honor Flight," she said, "what this?" I offered the short answer. "This you wear?" she asked. "No, no, my 91 year-old Veteran friend will wear it when we go to see the World War II Memorial in Washington," I answered. "Veteran," she said, her mind working, "I do for him, yes," and with a bigger smile, said this powerful truth, "If not for Veteran I have no place to come to."

Two days later, as promised, she produced the transformed size L t-shirt. Knowing how no one likes to wait for something, I delivered the shirt on my way home. At first I had a little trouble explaining how a t-shirt labeled XXL was really a size L, but when he understood that it had been remade just for him, you would have thought he just made a hole-in-one.

Other than t-shirt alterations, the job description of guardian was to accompany the Veterans through airport security, help them board and disembark, sit, walk and talk with them, point out access ramps and restrooms, tote cameras and pill bottles, provide an arm to lean on, circle up chairs under a big tent, and secure our box lunches. But more importantly, we were there to listen, offer strength, and stand by them as they, the heroes, gazed into the Memorial, reflected on their own thoughts, and opened up the history books of their lives to us on that magnificent day not one of us will ever forget.

I haven't been able to get that day out of my mind. It was such a privilege and honor to be with those men on such a gift of a day. But I've also been thinking about how much my job that day mirrors our job

here, as Financial Guardians. We listen and plan, we direct and monitor, we share highs and lows, and offer our support and strength through all the stages of life's journey.

This year has been a journey indeed, and our job as guardians has never been harder or more needed. Seven short months ago, a media-dominated, worried nation wondered if *this* time the headlines might be right. Investors whose parents lost everything during the Great Depression told us so. Fear spiraled. Sellers sold, buyers backed away. Stocks skidded, hitting low levels not seen in many years. As advisors, we bore down to figure out what our investments were really worth and what was really driving the market. The answer: bad news begat fear begat selling begat more fear and so on. We remembered John Templeton saying, "Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria." We clung to that, hung on to our positions, owning more stocks than we normally would, while strategically moving up the quality chain and diversifying away some risk. We waited for rationality to return, figuring it could be many quarters or years away.

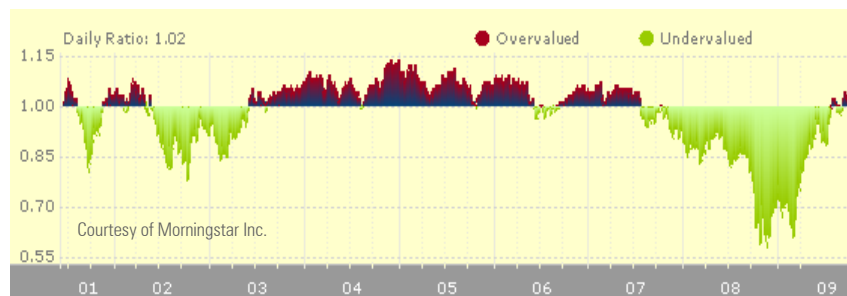
Then out of nowhere, here we are today: the S&P500 is up nearly 20% for the year (and up nearly 60% off the March lows), corporate bonds are up nearly 15% and 10 year treasuries are down 6% year to date. Again, we have to ask where we are, how we've gotten here, and most importantly what it means to be a guardian. Our short answer: the market has gone far past "fair value," mostly on the backs of low-quality stocks, and caution is the order of the day.

A Low-Quality, Speculative Rally. Like a tightly coiled spring, the assets that were most depressed in 2008 and early 2009 let loose when the world did not, in fact, come to an end. Any way you slice it, this six-month rally has been driven by the lowest-quality assets (in both stocks and bonds). Small stocks have outperformed large stocks, Newspapers and Financials have outperformed Regulated Utilities, and, most telling, No Moat stocks have outperformed Wide Moat stocks (for more about moats, see our Q1 2009 commentary "What's Really Important: Price, Moat and Uncertainty).

Instability in the Background. Throughout this rally, we've seen large improvements in the real economy, but we're nowhere close to out of the woods. After shooting up to record levels, the personal savings rate has slowly drifted from 5% in June, to 4% in July, 3% in August and although September data is not yet available, our best guess is that the trend continues. Unemployment has crept up to 9.8% (and even *that* number doesn't capture the underemployed and discouraged who are no longer looking for work.) The government has promised a \$1 trillion per year deficit for the next ten years. Housing and Consumer sales have been temporarily bolstered by government programs that are all but over.

Caution is the Order of the Day.

The need for caution doesn't just come from the gloomy statistics mentioned above, but it also seems that caution could provide very satisfactory absolute (not just relative) returns. In raw numbers, we see the market as a whole selling for approximately what it's worth (102% of fair value, see above.) However, the businesses with



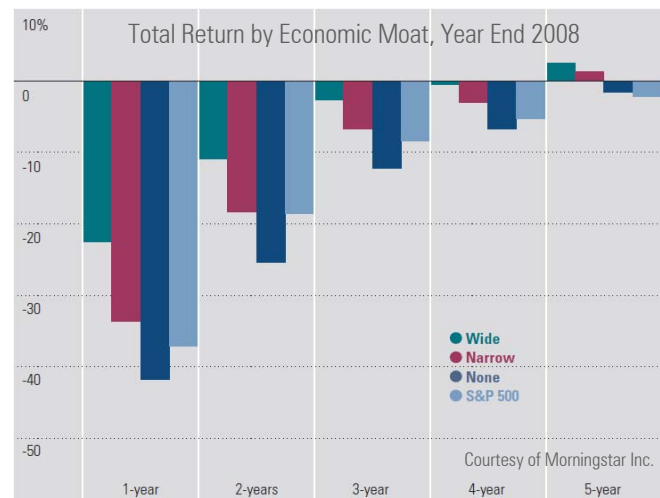
Wide Moats are selling for 88% of fair value (a 12% discount!) in contrast to the No Moat businesses that are currently overvalued (109% of fair value). Using the same yardstick, the US stocks in our separately managed portfolios are selling for 74% of fair value, with a 3.4% dividend yield on top of that. We structure these investments along with foreign stocks, domestic and foreign bonds, commodities, and real estate to provide our clients with a diversified portfolio that delivers a large portion of its expected return in the form of interest and dividends (which can then be used for income needs or reinvested in the market.)

I have a good friend who could probably sleep through a jackhammer pounding in the next room, but if he heard a set of keys rattle in the middle of the night, he'd shoot straight out of bed. Why? He was a prisoner of war for a long, long time. Although he learned quite a lot during those solitary years, he never quite learned to like the sound of a jailer's keys. As guardians, we're constantly learning to ignore the sound of the jackhammer, however loud it gets, and listen for the keys that the average investor might miss. Seven short months ago that jackhammer was unmistakable: "sell now, get out, run for cover." We mostly ignored the rumble of the pavement and thankfully went about our business. Today, the jackhammer is a little more subtle (mostly from uncertainty), encouraging the investor to "seek the highest risk, make up lost ground" without regard for what the investor can stomach financially or emotionally.

We recently met with a client who, while happy with her portfolio going back up, wondered if she'd ever get back to the high water mark. That's the sound of the jackhammer. We reminded her that we were accomplishing her goals now: producing a dependable income stream that meets her needs, on the backs of high quality, diversified investments that still have plenty of potential to appreciate. Now, that's the sound of the keys jiggling that many investors miss. She quickly recognized the difference and wanted to pursue meeting her real-life goals, rather than just a number.

And even though we've been financial guardians for nearly three decades, we never know what Mr. Market's next move will be; that's a fool's errand anyway. But, we *do* know that businesses that tend to produce high returns on capital will increase in intrinsic value over time and that those companies will tend to outperform the market (see chart right).

We know that owning investments across a number of different asset classes smoothes out the volatility of returns. We know that we sleep better when a large portion of our expected return is being paid in the form of interest and dividends. And we know that we've never felt better positioned for a quickly changing and uncertain world.



Jonathan Smith
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