

July 15, 2010

It seemed like a really great idea at first. And it actually was, but somewhere along the way, it turned bad, really bad. I'm not quite sure when, but it was either before or after a tenant started breeding Pit Bulls in the back bedroom . . . well, now that I say that, it was probably before. The story starts a good six years before the Pit Bulls. I was just finishing my freshman year in college. Four friends and I were looking for an apartment that would rent to five college kids, but no one would go above four (that should have been my first hint). So I hatched an idea and floated it past Jonathan (side note: I quit referring to him as "Dad" after my first day of work here). I proposed that we use my first-time homebuyer status to get a cheap loan, then buy a four bedroom condo, cover our mortgage with the rent from my four roommates, and on graduation day we'd easily sell it and voila, three years of rent free living. I was, as we say, *very* bullish.

It worked well for the first three years. In addition to the rent working out as planned, I happened to meet my wife, Millie, who was living in the building next door (I later learned she had made the same proposal to her Mom and they owned her condo also – the serendipity!) Three years later, my roommates became my groomsmen when Millie and I married a month after graduation and, even though we couldn't sell the condo right away, we found some decent tenants to tide us over for "just a few months."

That first batch of tenants sent their checks in on time and didn't scuff up the walls too badly. But as we continued to rent it out while looking for a buyer, we discovered each group of tenants brought new troubles. Our costs went up: carpets had to be cleaned after each tenant, washers broke, and rooms were painted black. And our emotional expense went up as well: lost sleep over dealing with missed rents and worry over our exit price. All the while our potential liabilities piled up: the smoke detectors went unattended, the 3rd floor porch railing was removed for an impromptu golf driving range, and of course the aforementioned Pit Bull husbandry. Thankfully, the world is full of enterprising young men with four friends who want to live together – we were lucky enough to sell our place to one such "investor" well before the housing market collapsed.

The Tenants or "You're Going to Let *Who* Stay in Our Hotel!?"

We have a good friend who refers to monthly statements and the flashing data on CNBC as "Arabic Numbers" because they have no real significance without someone willing to interpret and apply them to a specific investor's situation. One of the "interpretation" tools we use is to view our investment portfolio through the eyes of a Landlord. As far as we're concerned, every investor, from the parents saving for college to Warren Buffett himself, is the Owner and de facto Landlord of a 100 room hotel. Each room represents 1% of their portfolio and each Landlord has the choice to rent out each room to a variety of tenants with various quirks. We'd like to introduce the tenants and shed light on how this framework helps us see and navigate the current environment.

•	۱	۲	۳	۴	۵	۶	۷	۸	۹
0	1	2	3	4	5	6	7	8	9
sifr	waahid	oeth-nayn	thalaatha	arba'a	khamisa	sitta	sab'a	thamaaneeya	tis'a

Arabic Numbers: Where the 4's look like backwards 3's

Bonds: We have a wide spectrum, but let's start with our average Bond. We'll call him James Bond and he agrees to pay us a stated rent and even shows us his estimated payment schedule. In addition, if we let him stay and don't evict him before the term of his lease is up (if we don't sell our Bond before maturity), then James promises to leave the room in the same condition he found it. At one end of the spectrum, we have our safest Bond, a US Treasury, who we'll call T. Bill Bond. Bill has never missed a payment in over 200 years and is pretty well regarded globally. He won't pay us as much rent as James, but we usually sleep well at night with him in our rooms. At the other end is the riskier High Yield Bonds, we'll call Barry Bond. Barry has high hopes and offers big promises. He owes a lot of money to his lenders and doesn't have the best track record of paying his rent. The only reason we let him set foot in one of our rooms is because he promises to give us a large rent check . . . and, like all Bonds, we have a legal contract we can enforce in case he backs out.

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Stocks: We have a very curious relationship with our Stock tenants. It really couldn't look more different from Bonds. In most cases, we allow Stocks to stay with no promise or expectation of a monthly rent. Why? Well, our proposal to Stocks goes like this: we let them stay rent free with no lease agreement in hopes that when we kick them out (sell them), they'll pay us all their "back rent" in one lump sum payment. It sounds pretty preposterous, but history shows that over long stretches of time, Stocks pay a pretty decent rent. It's like they are so thankful for a place to "live" while they sell their iThings, Microthings, and Googletings that they are happy to share in the profits when they move out.

Of course, there are plenty of times when Stocks *don't* pay rent when they move out. The best outcome in that situation is that they leave the hotel room the way they found it and we can just rent it out again to whoever we choose (we have no loss on our position). The worst outcome is when we rent a room (or worse, multiple rooms) to someone like those Lehman Brothers or someone who will go unnamed but whose initials are AIG. They not only stiffed their Landlords, but they stole bathrobes, set the drapes on fire, and got the hotel room permanently condemned.

Dividend Stocks: A subset of the Stock tenants is the Dividend Paying Stocks. These Dividenders say they'll pay a monthly rent, but they give no legal promise. In fact, all that the Landlord has to go on is the Dividender's history, their word, and their deeds. This can leave the unsuspecting Landlord open for much disappointment. We've seen it plenty of times (and even been tricked ourselves); some Dividenders say they'll pay rent but end up over-promising and under-delivering. Inevitably they don't pay the advertised rent, or even a fraction of it. When the Landlord gets fed up with their broken promises and kicks them out, they find a hotel room that looks like it was inhabited by an '80's Rock Band. This is why our "screening" process for these Dividenders goes far beyond looking at last month's rent check. As we've mentioned in prior commentaries, we look at their rental history, "job security", other financial obligations, and, most importantly, their ability and willingness to increase their rent payments.



3rd Floor Driving Range: Do Not Try This at Home

Gold: Just when it seems that we couldn't get much different than the above mentioned cast of characters, we meet the most unusual fellow of all: Gold. On the surface, he seems like the last person we'd want to rent to: he has no job, no real prospects for employment, he promises no monthly rent and his only redeeming attribute is that he's a snazzy dresser . . . and, or course, he's always been a hit with the ladies. The only way that I, as a Landlord, can make a profit by renting to Gold is by pawning him off on the next Landlord who pays me a premium. Today, Landlords are clamoring

for Gold – they're paying close to historical highs to prior Landlords just for the opportunity to let him in their rooms. This isn't to say he's a bad guy. He has a long history of being the go-to tenant in times of uncertainty and fear – it's just important to know what we're getting into. Warren Buffett agrees when he says about Gold, "It gets dug out of the ground in Africa, or someplace. Then we melt it down, dig another hole, bury it again and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head."

Cash: After all these instances of skipping rent and trashing rooms (it feels like I'm watching Tom Hanks in *The Money Pit*), one doesn't have to explain the appeal of Cash. In effect, owning Cash is the equivalent of putting a "No Vacancy" sign on any number of doors. While we won't collect any rent, we're guaranteed to have our room in the condition we left it – chocolates still on the pillows and the toilet-paper roll still folded into a point. Of course, an empty room provides little comfort when costs inflate.

The Landscape or “Where’s the Rent Coming From This Month?”

That’s a lot of words spent on setting the stage, so we’ll get right to the point, which is what we see happening in the markets. Recession, Inflation, Deflation, and Interest Rates seem to be on everyone’s mind, so we’ll spend the rest of our time there.

Recession impacts our Stock tenants just like it would any real-life tenant. If Joe Stock’s income is squeezed, he has less money to spend on rent. Same goes for the Dividenders, if they aren’t committed to sending their monthly rent check, they will either reduce or eliminate it all together. We think the probability of another recession (or just continuing the one we may not have ever really exited) is about 50/50. Add in the possibility of large tax increases in 2011 which bring a “negative multiplier” effect (it hurts growth 2-3x more than it helps tax revenues) and a recession gets more certain. The key to renting to Stocks when the shadow of recession is in view, is to only offer rooms to those tenants with secure jobs and predictable salaries, and to have realistically low expectations for “exit rent” that would still make it worthwhile to the Landlord.



The Money Pit tagline is eerily appropriate: “For everyone who’s ever been deeply in Love or deeply in Debt”

Inflation is the silent killer of the hotel business; most evidently in our Cash and Bond rooms. We see it in our hotel’s rising prices of utility bills, staff health insurance and pool maintenance. While our Stocks have jobs that will likely pay them more in times of inflation (thus passing that along to the Landlord) our Bonds have contracted a set amount of monthly rent and our Cash is paying us nothing. While we think it’s a near certainty that we’ll have some period of rapid inflation in the US, the question is “When?” We, for one, do not want to be holding a massive amount of Bonds when inflation returns, forcing interest rates to shoot up, and we’re stuck with an undesirable tenant.

Deflation, a decline in prices, is the flipside of inflation. It’s easy enough to see that this has the opposite effects of inflation and, from where we sit, this seems to be a likely short-term scenario. Even though the Fed is printing money and injecting stimulus, if banks and consumers are holding on to funds at an even faster clip, the end result is that money is being taken out of the economy, prices quit going up, and interest rates go lower. In our Portfolio Hotel, deflation will favor Bond holdings (because we’re happy to collect their now relatively high monthly rents) and favor the Quality, Dividend-Paying Stocks over the Non-Paying Stocks (again, due to the rent coming in). If and when we see deflation, we don’t think it will be a long period and we’re not ones to want to stake long-term assets on a short-term event. So, while we have adequate Bond exposure, we’ve stopped short of overweighting this short-term scenario. Rather, we’re choosing to “bet” on deflation by being more certain that our clients have adequate personal reserves and are paying off any expensive debts. In other words, we’re less inclined to rent out rooms that we might want to live in over the next couple years.

Mr. Buffett reminds us, “Be fearful when others are greedy and be greedy only when others are fearful.” We’d rephrase that for our hotel analogy to say, “Rent out your rooms when other Landlords lock their doors, and light up your ‘No Vacancy’ sign when others swing the doors open wide.” While we expect overall returns going forward to be lower than historical averages, we are by no means disappointed with the tenants we’ve opened our doors to. Rest assured that we, as the Landlords of our clients’ Hotels, have filled our rooms with a mix of renters that we fully expect to help our clients reach their goals regardless of the larger macroeconomic outcome.

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