

December 5, 2003 Commentary  
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S&P 500: 1069  
NASDAQ: 1968

### **Giving Thanks**

#### **I Love You; I Just Don't Like What You are Doing to Yourself**

#### **Revisiting the Hidden "Net Worth" Tax, and a Hidden Consumption Tax Coming Two Eternal Truths**

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#### **Happy Holidays!**

### **Giving Thanks**

What a great Thanksgiving! I hope you had as nice a time as I-spending it with close family-maybe friends. Erica and I had my mother in town Wednesday through Friday and then I had the opportunity to catch up with some good friends from college Saturday night. We have much to be thankful for. For me, second to being able to share my life with Erica, it is the utter, dumb luck of being born in this country. A country which has ascended so quickly from an emerging market to the largest market in the world in a matter of 227 years. Sadly, we are going through some difficult challenges now. On the heels of my last commentary in October about foreign central banks buying our bonds to serve the dual purpose of keeping their domestic currency weak against the dollar AND keeping our interest rates down, I appreciated Alan Abelson's comments in Barron's and join him in thanking the Chinese and Japanese for "recycling (our dollars which they have acquired from the U.S. consumer) into U.S. government and agency securities..." These purchases of \$150 billion over the past year have literally financed 25% of our trade deficit which is now over \$550 billion. As I stated graphically in my seminar, this is supporting a benign, virtuous cycle while we attempt to bring the imbalances back to even.

### **I Love You; I Just Don't Like What You are Doing to Yourself**

In reviewing my past commentaries it came to my attention that I may come across as a bit unpatriotic to those that don't know me so well. This is far from the truth. After all, I still carry around a credit card, which is as American as apple pie. My credit card even looks like a waving American Flag AND I bought a pumpkin pie with my American Flag waving credit card on Thanksgiving Day!!! Okay, the story would sound better if I had bought Apple pie but it was Thanksgiving and there is nothing I like more than pumpkin pie on Thanksgiving. The point is I love my country; I just don't like how it is hurting itself right now. Anyone can relate to this feeling, especially parents: "I love you, I just don't like what you are doing to yourself", a parent might say to their child.

“President Bush has yet to meet a spending bill he doesn’t like” (from Review & Outlook-the Wall Street Journal). Reading that line really hit me in the head as it is exactly what I have been thinking over the past few months. I don’t like what is going on with my tax dollars. Correction: I don’t like what is going on with the tax dollars that I’ll be paying in the next 5-15 years since it is obvious programs being instituted today will be paid for in the future, not today. I read another letter to the Journal commenting on how the politicians of California have preferred to spend future tax dollars now rather than keep spending on a par with collections. SO TRUE!! Whose fault is it? The politician, who is told by his constituency not to raise taxes but to vote for every program it wants, or the constituency itself for making unreasonable demands? Enabler or Voter? You tell me. **Solution:** Cut every, and I mean every part of the budget by 4% per year for the next 5 years. Assuming receipts stay the same that would lead to a balanced budget. I base this on fiscal year 2003 outlays of \$2,156,553,000,000 versus receipts of \$1,782,302,000,000 from the Department of the Treasury website. Oversimplified? Maybe.

### **Revisiting the Hidden “Net Worth” Tax, and a Hidden Consumption Tax Coming**

You see, all this new spending with no revenue offset comes out in the wash. You know it and so do I. I’ll tell you the two ways it comes out down the road, one of which may surprise you and it's been going on all your life. The first way is that somewhere down the road taxes need to be raised to make interest payments and make redemption payments at maturity of all these government bonds we are issuing. Per my comment above of politicians more focused on re-election than helping their constituency help themselves, I don’t see taxes being raised enough to cover this bill. So how will we pay off these debts? The answer is the Hidden “Net Worth” Tax called inflation. Ask yourself how much \$5000 bought for you 30 years ago versus today. 30 years ago you could buy a pretty nice new car with \$5000. Now you need to spend \$30,000 on that same car. This reflects a decline in your real net worth. It is caused by our government preferring the printing press over fiscal discipline. I love our country; I just don’t like what it is doing to the dollars that we hold today.

The coming “hidden” consumption tax is the price of oil in U.S. Dollars. Despite an economy which is not exactly in a feel good mode and not a lot of signs of sustainable renewed demand, oil prices will remain firm to higher, thanks to the weak dollar. You see, OPEC (Organization of Petroleum Exporting Countries) has decided it may cut production in order to keep the price up due to the declining dollar. Most of its members sell in exchange for dollars, which, as you know, are depreciating. In order to offset the depreciating dollar, they must keep prices firm to higher. An increase in prices of raw materials such as oil is one of the main causes of inflation. These price increases must be passed on to the consumer in order to maintain profit margins. Now we have asset inflation in stocks, houses AND oil. This should come as no surprise to clients as they have good exposure here (in addition to precious metals) and are benefiting nicely. Remember, given constant demand, goods of limited supply should appreciate in terms of an exchange medium (dollars) that is increasing in quantity.

## Two Eternal Truths

During the seminar that I gave to a few (lucky) prospective clients on November 12<sup>th</sup>, I described myself as “Optimistically Realistic”. While I may be down on our country’s fiscal behavior and the future of the stock market, I am excited about my future and my clients’ financial futures. That is because I have embraced the reality of two eternal truths AND “Hey, I’m okay with it”, regardless of how the market behaves in the near term: **1) Empirical data reflecting measured quantities, in the long term, show prices always return to their historical mean.** That means an overvalued market will eventually become undervalued to offset the period of overvaluation. Inversely, an undervalued market will become overvalued to compensate for the prolonged bear market. While in general the stock market is amidst a prolonged bear market to offset the twenty year bull which culminated in 5 years of extreme overvaluation, my clients are participating in the beginning of a long term bull market of another kind, which is working out the excessively good value created during a twenty year bear market.

**2) What goes around comes around.** I was reading Barron’s last weekend when I read words that sent a chill down my spine. A little background: We have a debt rating system of which you are probably aware. It’s like a credit scoring system for publicly traded loans which are called bonds with ratings ranging from Aaa/AAA (best) to D/D (worst-in default). There are two major ratings agencies which is the reason for the “/” slash. Moody’s is before the slash and Standard & Poors is after it. Needless to say, the obligations of the U.S. government are Aaa/AAA rated-as a matter of fact, the traditional teachings of Investing 101 would have you think that if there was one higher rating, our government bonds would have it. They are considered “*risk-free*”. Back to the story. I stopped reading and pulled Erica out of what she was doing and read it to her. I was already thinking about how the market might handle it the next Monday.

Here it is: **“On Notice: Moody’s Investor Service warned the U.S. will need to improve its finances in the next few years to retain its Triple-A debt rating.”**

Now, read that again.

The really crazy thing is this was not a headline or cover story. In fact that line was inserted as part of the goings on of “Last Week” between the NASD proposing rule changes regarding IPO’s and “Odd’s and Ends”. Like many items one would think would cause a reaction, I have yet to see a reaction in the markets to this one. It just goes to show me that the big money is more concerned about today than tomorrow. How foolish of me to ever think otherwise?!!!

Bottom line: You just can’t keep buying whatever you want with money you don’t have. Eventually the cycle slows and reverses on you. The FED has been eager to extend that cycle and I believe it has only delayed the inevitable and that it will be worse when it reverses. The FED is confident we can avert the pain of a recession and still clean out the excesses of a bubble. I don’t think that is possible. Providing more money to loan at ever lower rates only does one thing...it leads to more borrowing. Usually a recession provides an opportunity to cleanse. Not this time. Two years after the official end of the

recession, debt levels are still high and the number unemployed for longer than 6 months is just barely showing signs of leveling off. This morning we are seeing signs that the 3<sup>rd</sup> quarter “miracle” of 8.2% GDP growth is not producing sustainable benefits for those seeking jobs. True, the unemployment rate ticked down but the job creation number is way below the 150,000 monthly needed to absorb new entrants and sustain our economy. Hopefully, this is just a pull back in an uptrend-we shall soon see!

### **Getting Results: Comparing Your Reward For Your Risk to the Market**

I talk a lot about getting the best reward for your risk. It seems like a simple enough concept which we apply to just about everything we do but how do you apply that to investing? One commonly used measure of risk is a stock's beta. Beta measures systematic risk of a stock. Systematic risk is risk to which the entire market is subjected. Examples of systematic risk include market risk, interest rate risk, exchange rate risk (fluctuation in the value of the U.S. dollar), purchasing power risk (inflation), and reinvestment risk (changes in the rate of return earned on future interest and dividend payments that are reinvested). Thus, beta measures how volatile an individual security or portfolio is compared to the market. Unsystematic risk, which beta does not measure, describes risk specific to that security, such as internal financial risk, regulatory risk, default risk, and management risk. This risk is managed through fundamental analysis and, as you are aware, I am very pick here. So back to the beta: stocks which are highly correlated to the market have a beta coefficient of 1. A beta of less than 1 means that the stock is less volatile than the market and a beta of more than 1 implies greater volatility than the market. Typically, if one is to invest in a higher beta stock than the market, they would expect greater swings than the market. So in an up market you outperform and in a down market you underperform. Conversely, stocks with a beta less than 1, being less volatile, should achieve better relative returns in a down market and worse relative returns in an up market.

The idea behind investing is to find the best returns for the least risk. In an exercise leading up to the seminar I jotted down all the stocks held in your accounts along with their respective betas. I also jotted down the year-to-date performance of the stocks, although your experience in these stocks may differ due to your particular holding period. In any case, the idea is to see if we are invested in good performing stocks considering their volatility. Remember, a beta less than 1 generally does better in a down market and underperforms in an up market. As of the end of the third quarter the S&P 500 was up 13% with the average of the stocks held in our accounts up 41%!!! Here's the kicker: the average beta of our holdings was actually less than the market beta, coming in a .66!!!! That is the goal-better relative reward for less relative risk.

### **Happy Holidays!**

As I mentioned above, I have much to be thankful for: your support being very important. The seminar in November was just about booked before the invitations even went out, thanks to your kind referrals. My goal, with your help, is to do that again in January. Please keep this excellent service in mind over the holidays as you join family and

friends. Many have loved ones whom they feel should be consulting a financial professional and I appreciate you passing my name and number on. Don't forget the "Tell A Friend" button at the website!!

Finally, have yourself a safe and pleasant holiday this month. I wish you much enjoyment as you visit parents, children, grandchildren, cousins, nieces, nephews, and others. The New Year is coming and we should all be excited about what it will bring. I'm thinking of making some changes to this Commentary so if you have any suggestions, fire away!

Successful Planning to All,

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