



Registered Investment Adviser

March 1, 2010 Commentary
Justin B. Friedrichs, CFP®

S&P 500: 1104
NASDAQ: 2238
Gold: 1110

“No generation can contract debts greater than may be paid during the course of its own existence.” –*Thomas Jefferson, in a letter to James Madison in 1789*

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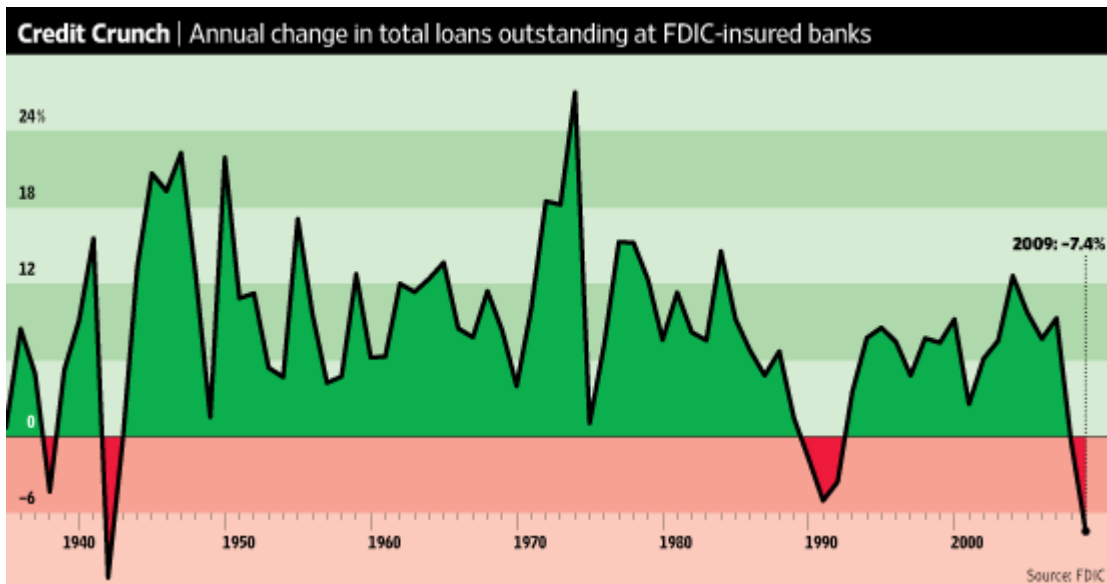
Markets

In our last *Update* I discussed how debt is ultimately going to overhang the economy and our markets for an indeterminable amount of time. In addition, I remarked that we would not see any significant opportunity for broad market upside performance until we experience an extended period of debt reduction as a society. (Society includes both Government and Private Sector) This major overhang obviously remains. Another overhang which I have been discussing since 2001/2002 is the valuations investors are paying in the market. Despite the nasty correction of 2008/2009, market valuations never got close to levels historically seen at bear market bottoms. In other words, investors buying now are speculating on a rally which is unlikely to be sustainable. Despite the debt overhang and the valuation issue, many short term "solutions" will come to pass, only to fail in the longer term. You see, every time the government intervenes, it not only does not end the crisis, it draws it out. Nothing can stop the force of the free market from completing its process. Whatever attempts to artificially alter the course of a free market inevitably lead to adverse unintended consequences.

Debt

A terrific example of adverse unintended consequences of government intervention is the horrendous idea that any institution is "too big to fail" and the accompanying taxpayer assistance. All the big banks we bailed out are doing alright for now, thank you. How has this helped the taxpayer? Zilch. In fact, the little banks, where the taxpayer has his

money, are in huge danger due to real estate speculation which came about as a result of extended, artificially low interest rates. You see, the original problem of having too many banks come into being is the result of cheap money being in place for far too long. When natural market forces attempted to naturally cleanse the "excess supply", the government intervened, again. There were, and are, literally hundreds of regional and small banks which could have issued stock to buy the remaining productive part of these big banks. This would allow for the supply of banks to diminish AND maintain lending services to the average American small business owner. The unintended consequence of government intervention is that, while the big banks are doing alright (for now), they are not lending to small businesses where jobs are most readily created. So the market is lacking the superior service levels delivered at smaller banks while the big banks that taxpayers bailed out are not servicing at all!! In fact, I recently read in the Wall Street Journal that loans outstanding declined at the most rapid rate since the end of the Great Depression!!



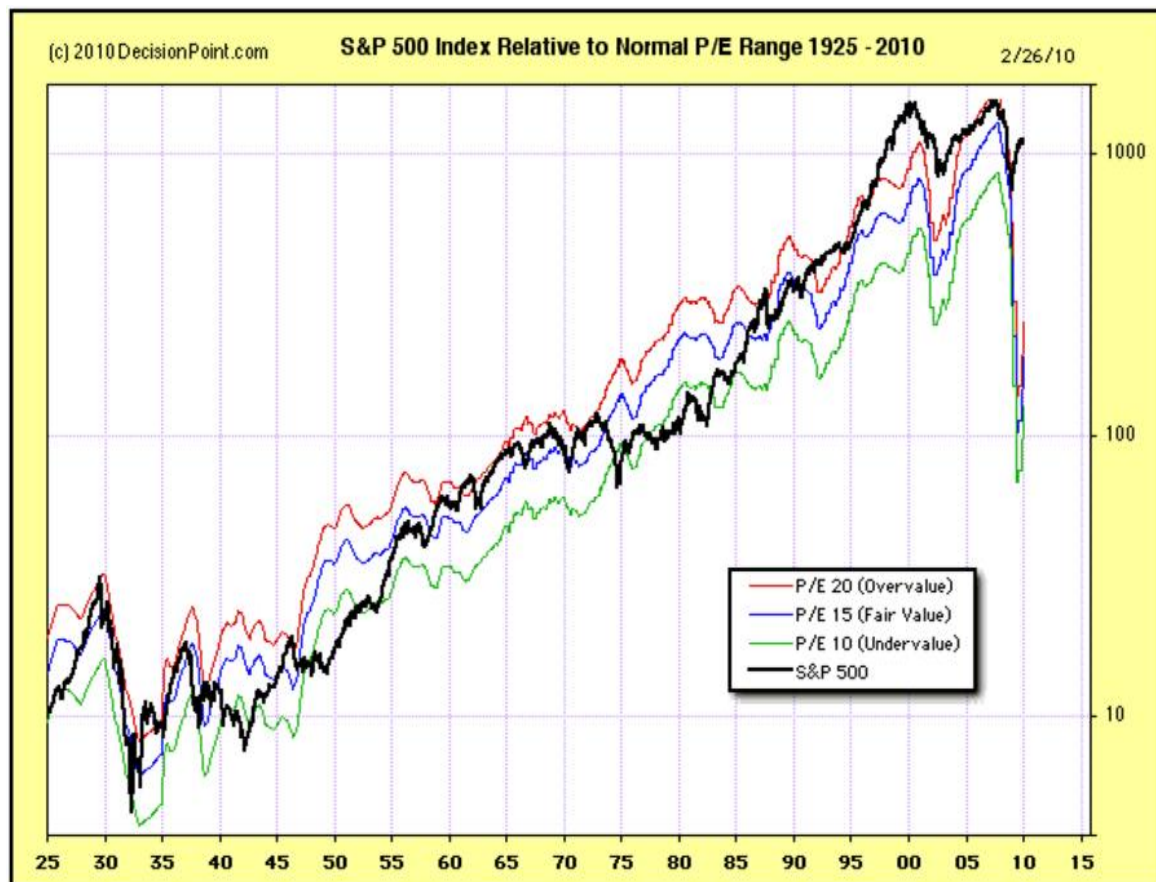
(Wall Street Journal Feb. 24, 2010)

This is bad for the economy, but if my theory is right about declining debt levels leading to market bottoms this is eventually going to be good. If banks aren't lending, then the only thing going on with debt is pay-down. I'd prefer a scenario where lending perks up a bit to help those qualified borrowers who want to expand business while debt is being paid down.

Valuation

When you invest in a business you pay for a stream of income. A common way to measure how much the business is worth is to apply a multiple to the stream of income. I like to think of it as "How many years will it take to break even?" In other words, if I invest \$10 and the income is \$1, it will take me 10 years to get my money back - a Price to Earnings multiple of 10 therefore exists. If the \$1 is expected to grow one might place a higher valuation on the company and vice versa. For the past 100 years or so the S&P

500 has cycled from this undervalued level of 10 to the over-valued level of 20 based on GAAP, as reported earnings and back to 10 several times. The entire cycle generally last 30-40 years with Bull markets lasting 17-20 years and bear markets lasting 12-17 years. Currently the as reported S&P P/E ratio is extraordinarily high at around 88, reflecting extremely small earnings reported during the past year as a result of big losses by large members of the S&P 500. To get an idea of what things look like going forward the S&P 500 trades at a P/E ratio of over 20 based on 2010 estimated as reported earnings. In my view there is a lot to fear in terms of economic and market performance risk and a P/E ratio of 20 does not discount at all for this risk. So it might be surprising but despite the volatile gyrations of the past 10 years, the market has yet to become a good undervalued play and is now probably 30% over-valued at the minimum.



(courtesy of www.decisionpoint.com)

Observing the above chart shows the S&P 500 (black) oscillating from below the "undervalued" line (green) to above the "over-valued" line (red) and back over history. One can clearly see not only the pattern but the blatant refusal of markets to discount risk. This can be attributed largely to the artificially low interest rates set by the FED which have forced market participants to take more risk in order to play for a reasonable return.

Our Portfolio This Year

Despite the negative outlook for U.S. Stocks in this *Update*, I have good news. In the last *Update* I referred to our balanced approach of betting on gold and betting against the market. Thus far, this has allowed your accounts to prosper in down markets and "hang in there" in up markets due to the strength of our gold position. My position has been that as the market puts in a major top (major meaning a level that will not be seen for several years), gold will put in a significant bottom (a pullback following its recent surge through and sustained claim of the \$1000 mark). In other words, despite gold and markets behaving similarly over the past year or so, I believe they will de-link once again as gold is transformed from a speculative/greed trade to a fear trade. The timing of this combination of reversals is difficult but I am thinking the January top for the S&P 500 may be it for the broad markets and the early February lows for gold may have done the trick. I am more confident in the market call, though, than the gold call, which is why we are currently investing more heavily against the market than we investing in favor of gold. The attached chart speaks to this draws one basic reason for this confidence. You'll see the volume trends on the bottom of the chart indicate declining participation as the market climbs and rising participation on declines. This speaks to the level of enthusiasm with which money is being put into play in either trend. Clearly, to be confident in an uptrend, we want rising participation/confidence.

In early December we had reduced our gold position to its smallest size in years just prior to an 18% correction. In early February we added a bit back on and this second layer (on top of our core position) 20% below our sell price in December and it is now showing a 5% profit. In late December/early January we put on a couple of more investments against the market. We exited one of these with about a 20% profit and it is now back in our portfolio at a level decently below our exit. The other is down about 5% right now. As the broad market corrects, I think it will be a slow, painful process as demonstrated by its start from early January to now. The bottom line is that it seems as if our balance is working out to reduce volatility and increase your bottom line should markets continue to decline.

A Stock We Own

In other news, ATCO reported a great quarter with good profitability and over 100% revenue growth. How many companies are doing that right now??? This one is going to zigzag quite a bit but I think the conviction in its profit sustainability will grow over the next quarter or two which should then command for it a valuation of 20 times operating earnings. This puts my current 12 month target at about \$3.50 per share. Incidentally, the company is changing its name to LRAD Corporation so be on the lookout for a possible symbol change in your portfolio. Here is an article regarding its main product in case you are interested:

<http://www.reuters.com/article/idAFLDE6200ZR20100301?rpc=44>

Successful Investing to All!

Justin

Justin B. Friedrichs, CFP®
Friedrichs Asset Management LLC
Registered Investment Adviser
6767 Forest Hill Avenue Suite 305
Richmond, Virginia 23225
(804) 272-6070

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