

January 2005 Commentary and Outlook  
Justin B. Friedrichs, CFP®  
Friedrichs Asset Management LLC  
Registered Investment Adviser

S&P 500: 1183  
NASDAQ: 2080

### **A Quick Personal Note**

Thank you for a great year. Assets under management have grown dramatically since the founding of Friedrichs Asset Management and 2004 was no exception, with assets growing by 48%. This could not have been possible without the loyal and heartfelt support of you, my friends and clients. Many of you already know, but Erica and I are expecting our first child in February. I have always taken referrals as a personal (and professional) compliment, but it's amazing how much more it begins to mean when we think about our child's future. My feelings for this unborn child are already boiling over and help from my Friedrichs Asset Management (FAM) "FAMily" that ultimately supports the growing Friedrichs family is all the more humbling. The power of the combination of goodness and loyalty is unbelievable.

### **Good News Bad News Good News**

In return for your incredible support, I have some good news. The good news is that FAM accounts averaged a 9.63% return for 2004, before fees. This compares favorably to a price return of 8.99% return on the S&P 500 (the total return including dividends was 10.88%), 8.59% on the Nasdaq, 3.15% price performance on the Dow Jones Industrial Average and 4.34% on the Lehman Aggregate Bond Index. Even more exciting is that most portfolios I manage require that up to only 60% of the portfolio is to be allocated to stocks. This means that we are getting above average returns with large percentages of investment capital waiting in bonds and cash. The bad news is that while our investments did well, we were held back by my handling your accounts so conservatively (high levels of cash). I plan to make improvements to our investing system on an ongoing basis - keeping in mind the importance of risk controls. This includes analysis of our entry and exit point parameters relative to both the individual security's price action and broad market conditions. The goal is to achieve the best return for an assumed level of risk. Clearly, we are currently performing well on this front, but I am all about getting better. Let's talk about improvements.

It was frustrating to watch as stocks rallied strongly after the election while we maintained our conservative stock-picking discipline. My father always said the most difficult things about investing are sticking to one's discipline and maintaining patience. If one develops a discipline with which he or she can sleep at night, one must have the patience to wait it out when necessary. How tempting it has been to jump in to ascending markets while holding our noses to valuations?!! Fortunately, we haven't caved and we are earning well until the next awesome buying opportunity in the broad stock market presents itself. Having said that, I am not averse to allowing our discipline to evolve with

an ever-evolving market. One such evolutionary step will be the introduction of some slightly more aggressive buying of stocks that do make it through our rigorous fundamental and technical screens. Since these screens seem to be doing well even when the market is heading down, we should put more weight on their abilities. What I want to avoid is the inclination to get into the market “because it is obviously going up” or because there is nowhere else to get a decent return. These are not legitimate reasons to risk capital that would otherwise be intended for safety.

## The Commodities Bull

An example of exercising our discipline, even against my long-term beliefs, was our recent exit of many of our riskier gold and oil stock investments. While the Gold bull market will go on through this decade - or at least until a currency crisis climax a la 1987-recent indications have led me to back off temporarily and see, if like all major bull markets, a mini-correction is not in the midst. Indeed, gold had become extended in price and it makes sense for it to pull back to longer term trend lines before resuming its advance.



(Chart courtesy of [www.decisionpoint.com](http://www.decisionpoint.com))

*Above: The HUI Gold Stock Index-we have been exiting all but core positions since October.*

### **A Contrarian Betting Against Gold**

On the surface, the above statement does not make a whole lot of sense because most people, in general, don't buy into the merits of gold ownership; therefore, anyone who does is by definition a "contrarian". Well, as you know, the gold bull has been riding mostly on (is inversely correlated to) the dollar bear market. Because gold is priced in dollars and the dollar has been declining in value, it follows that it takes more dollars to buy a relatively stable supply commodity like gold. As you know, I began to unload oil stocks when I saw the mainstream media consume themselves day after day with the oil bull - that meant to me that we were getting close to an interim pause as a result of everyone being on the same side of the trade. Once everyone has jumped in, usually the result of massive publicity, the number of new entrants in the form of investment funds is limited. Likewise, I am sure you have seen all over the mainstream media a saturation of articles about the declining dollar - months after, I might note, you read about it here! As a result, and being a contrarian, I just cannot stomach holding an investment or placing your hard-earned money on an investment theme that seems to be fully disseminated. So, we lightened up on gold stocks.

Does this mean the magic is over? Does this mean the secret we had is out and we can never look back to this area to profit again? Absolutely not!! As I discussed in the last *Commentary*, these behaviors and preference run in cycles. Everyone gets on the same side of the trade and the only way for the investment to go as a result is the opposite direction. All these newcomers are subsequently BURNED and go away, usually for a while, or at least until the investment in question hits the papers again and they find themselves asking "Why did I sell that?" This is why it takes time to build real, long-term support and momentum for a bull market. When this complete chain of events has been played out, the typical investor caves and buys in again. They usually buy in more heavily and stay in longer (remember that huge rally after the '98 correction?). It is at this point that the next stronger stage of the bull market ensues. We plan to be back in way before this happens, but for now, holding just a few core stocks will suit us fine.

### **Egg on My Face?**

Boy, I feel silly after boldly advertising my short-term thoughts in the last *Commentary* on the direction of the market. That dip did turn out to be a buying opportunity, albeit a tiny one, the gain on which is quickly fading as I write. This just goes to show you how maniacal the markets are now (and how bad I am at short-term predictions). Google trades at 200 times earnings (P/E of 200), Yahoo at 100 times earnings, and some investor sentiment polls are the most bullish since early 1987 - just months before a major correction in October of 1987. The power of drooling, salivating bulls is impressive indeed. This is where the "patience" comes in. We continue to watch the indicators and patiently await our opportunity to pounce on historically cheap values. In fact, the continued market advance certainly doesn't bother me as it tends to aid the cause of the individual picks we have made. The rising tide tends to lift all ships after all...it is just my opinion that the tide is rising on a big bubble of air.

I have mentioned in this *Commentary* and in my seminars that there is no historical precedent for a bull market starting at such high valuations as expressed in the P/E ratios and low dividend yields. Indeed, just as temporary corrections in the gold “bull” will shake off the short-term traders, so too will temporary rallies in this stock “bear” serve to bring in as many short-term traders as it can before resuming its downtrend. At the moment, it seems to be doing a terrific job at that!! So as long as I’m having eggs, in keeping with the tradition of market behavior, I’ll have them scrambled!

## **The Indicators**

Let’s look at the indicators introduced in the *January 2004 Commentary and Outlook*, which can be viewed along with other *Commentaries* by accessing the “Archived Commentary” section of the website: [www.FriedrichsAssetManagementLLC.com](http://www.FriedrichsAssetManagementLLC.com)) First, I’ll explain the rationale for using these indicators, then, you can see their current readings.

## **Explanation of Indicators**

“When Fear is at it height, Buy; When Greed is at its height, Sell” -my father, J.M. Gore Friedrichs. With these indicators, we try to assess the current levels of “greed” and “fear”. At times, we have contradictory readings. The best actionable points are when most or all are in line, as they are now.

**NYSE Bullish Percent:** This great indicator is from Dorsey Wright and Associates headquartered here in Richmond. This indicator tracks the percentage of stocks on the New York Stock Exchange currently on buy signals. Generally, the higher the number, the more buying has been done prior to the point of measurement. This could be an indication that less and less buying power remains out there, so at readings above 70%, we become cautious as the inevitable cycle of cash flowing in and out of the markets progresses. At levels below 30%, we become aware that a very good buying opportunity may lie ahead as most investors have probably already sold and are holding cash to fuel the next run.

**AII Sentiment Bull/Bear Ratio:** A weekly poll is conducted by the American Association of Individual Investors - what we call the individual public investors. This is a reliable indicator of the sentiment of individuals who are considered more emotional and less sophisticated than the “big money” investors. Since we don’t trust the emotions of the individual, this secondary indicator tells us when caution is warranted with high Bull/Bear ratio readings. Likewise, low readings can portend buying opportunities as markets tend to rally once the last little guy has bailed.

**NYSE + NASD Margin Debit Balances:** This is a monthly posting at the National Association of Securities Dealers’ (NASD’s) website telling us how much is currently being borrowed to own stocks. These are investors who actually borrow money to buy stocks and high readings generally indicate a frothy environment. The reason this is of particular value is that once the market turns, margin calls cause these borrowers to dump

stock more rapidly in order to repay loans; thus, the risk in the market grows at something more like an exponential rate as these debit balances grow. Low debit balances indicate that these risk-averse investors have finally caved and now are flush with cash and fresh borrowing power, and thus, buying power.

**Savings Rate:** This is the national savings rate and is gleaned from the U.S. Personal Income and Spending monthly report. My view is that the lower the savings rate the less disposable income with which the emotional public can use to load into stocks. A higher rate to me indicates more reserves on tap to fuel a strong bull market. From a contrarian standpoint, this indicator also tells me how optimistic John and Jane Q. Public are about the future. Low savings rates indicate high levels of optimism and probably a correspondingly high level of risk tolerance. This can foster an inclination among investors to count on and indeed borrow on “future dollars”, which tells me to be careful.

**Mutual Fund Cash:** This is the level of cash held in mutual funds. Generally, less than 8% is bearish and greater than 10% is bullish. I go a little further and like to reduce my risk by waiting for buying opportunities closer to 12% cash and for selling opportunities at less than 7% cash. This works the same way as the savings rate except that this is professionally managed money ready to be put to work. The more cash available, the better.

**Price to Earnings Ratio (P/E):** The historical average is around 15. We also call this fair value. There are many justifications in certain periods of time to accommodate higher levels, but the key I focus on is the historical tendency over decades of market action for this ratio to gravitate toward its mean of 15. Specifically, greater than 20 represents extreme overvaluations (proceed with caution) and less than 10 represents extreme undervaluations (back up the truck because the next 15 years should be good!). I use the P/E of the S&P 500, which represents 500 companies across the economy. P/E's are available on The Dow and NASDAQ as well. Bear markets usually bottom with P/E's around 8.

**Dividend Yield:** Again, using the S&P 500, this represents the amount of real money being distributed to shareholders as a percentage of their investment (the stock price). The historical average is around 4-5%. The higher the market goes, assuming a fixed dividend stream, the lower the yield. The lower the market goes, the higher the yield. Bear markets usually bottom with yields around 8%.

**Contrarian**

<u>Indicator</u>	<u>Greed</u>	<u>Fear</u>	<u>Current</u>	<u>Indication</u>
NYSE Bullish Percent	>70%	<30%	75.32**	<b>Bearish</b>
AII Sentiment				
Bull/Bear ratio	>2.5	<1	3.11*	<b>Bearish</b>
NYSE+NASD				
Margin debit balances	>160B	<100B	\$211B/Last here 11/2000!!	<b>Bearish</b>
Savings Rates	<5%	>12%	.3%	<b>Bearish</b>
Mutual Fund Cash	<7%	>12%	4.7%	<b>Bearish</b>

\*\*Declining from a peak of >86%

\*Recently we have seen readings not seen since 1987, the year of the last stock market crash, which like 2004, also followed 2+ years of >10% \$US Index declines each year.

<u>Valuation Indicator</u>	<u>Greed</u>	<u>Fear</u>	<u>Current/Last here</u>	<u>Indication</u>
Price/Earnings Ratio	>20	<10	<b>21.58/&gt;20 since 1997</b>	<b>Bearish</b>
Dividend Yield	<3.5%	>6%	<b>1.63%</b>	<b>Bearish</b>

In summary, it is useful to note that we are having to go further and further back toward the bubble years of 1999-2000 to see examples of some of these indicator levels in the past. Margin debt and Investor Sentiment are both at very high levels indicating a general perception of risk-free conditions.

Here are some interesting quotes to ponder as we select our investments:

*“...This situation suggests that international investors will eventually adjust their accumulation of dollar assets or, alternatively, seek higher dollar returns to offset concentration risk, elevating the cost of financing of the U.S. current account deficit and rendering it increasingly less tenable. If a net importing country finds financing for its net deficit too expensive, that country will, of necessity, import less...It seems persuasive that, given the size of the U.S. current account deficit, a diminished appetite for adding to dollar balances must occur at some point.”*

-Alan Greenspan, Frankfurt, Germany, November 19, 2004.

People frequently ask me how the increase in housing prices does not show up in the Government reported inflation figures (CPI). The following quote was interesting:

*“So, how did the Labor Department come up with just a 2.7 percent increase in housing costs? Easy. It doesn't measure what it really costs to buy a house. Instead, it calculates how much the cost of renting your own house (to yourself) went up over the past year. Read that again. Housing cost increases are determined by what you would have to pay to rent your own house this year, compared to what this fictitious rental payment would have been last year. The answer: just 2.7 percent. What about Fannie Mae's 13 percent (reported growth rate in home prices)? The Labor Department would probably argue that there's nothing wrong with Fannie Mae's calculation, it's just like comparing apples with elephants. The 11.3 percentage point discrepancy between its number and Fannie Mae's is simply what the homeowners' asset appreciated over the past year.”*

-John Crudelle New York Post Dec.9, 2004

I have discussed real estate in this *Commentary* before, particularly the speculative nature of house buying and rapid increases in values as a result of the FED artificially holding down short-term interest rates. This has been discussed in the context of the inherent risk which comes with such run-ups. I don't know if the members of the FED live in the real

world since it took so long for them to become concerned, but it was heartening to see an awareness surfacing:

*“Some participants believed that the prolonged period of policy accommodation had generated a significant degree of liquidity that might be contributing to signs of potentially excessive risk-taking in financial markets evidenced by quite narrow credit spreads, a pickup in initial public offerings, an upturn in mergers and acquisition activity, and anecdotal reports that speculative demands were becoming apparent in the markets for single-family homes and condominiums.”*

-Federal Open Market Committee minutes of the December 14, 2004 meeting.

### **Reflecting on 2004 and looking forward to 2005**

Reviewing the *January 2004 Commentary and Outlook*, it seems I was right and I was wrong. I said that while I thought the FED should raise rates, I also thought it would not be able to do so because it would not have a strong enough economy to accommodate higher rates. I was wrong as the FED raised rates. It had backed itself into the corner I described with rates so close to 0% and realized it would need to get rates back up to a normal level in case further stimulus was needed. But I was right about the economy not being able to accommodate higher rates in general. The supply and demand for borrowed money, as indicated in public markets, tells us that since the 10-year Note rate is unchanged from last January - there is not enough loan demand for market rates to rise. Moody's Aaa and Baa lending rates remained flat to down, respectively, indicating that borrowing interest remained flat. This tells me companies are not seeing enough demand out there to make long- term capital investments.

I don't expect much change from the current trend this year, except I do expect interest rates to rise on U.S. Treasury obligations as foreign central banks become disenchanted with their returns. Overseas investors who held these bonds got 4.4% from the bond but lost 7.2% on the dollars (as measured by the U.S. Dollar Index) in which they were denominated – this equates to a NET LOSS of almost 3%. In fits and starts, I expect the market to continue to make its way toward P/E's around the mid teens over the next few years and a rendezvous of P/E=10, over the next 5-10 year, would not surprise me. This year and next will be years in which corporate profits don't impress as much, leading to downward earnings growth revisions which will lead to lower valuations. The recently passed rule requiring corporations to expense options will certainly affect the reported earnings of public companies, particularly technology and start-up companies. Until now, these companies have relied on options to keep employees despite ultimately diluting shareholders' positions. The result will be lower earnings and thus higher valuations, which means these stocks will have to come down further before becoming good long-term investments. Currently, about 750 companies expense options and barring any roadblocks, all companies must comply with the new rule by June 2005.

## **The Long Term**

We have some great stocks right now. The key is to understand that great challenges lie ahead for us, our economy, our country, and our currency - the U.S. Dollar. I still agree with others who say the dollar is 20-40% overvalued and will resume its downtrend at some point. The recent hurried, low profile signing of an increase to the National Statutory Debt Limit only underscores the indifference the current administration has toward a continually weakening dollar. The thought process is that a cheaper dollar will eventually 1) stimulate capital investment in the U.S., which is accompanied by the associated hiring and 2) create demand for our exports. A sort of “unintended”, but welcome consequence, is that a weakening dollar allows us to pay back our debts with less, in real terms, than what we borrowed.

Debts and deficits contribute to a weakening of the dollar as perception of U.S. financial strength wanes, but the real trend is driven by the massive differential in wages, prices, and standards of living between what is rapidly becoming the old world manufacturing center (U.S.) and the new world manufacturing centers (China, India and the rest of the Asian bloc). This gap will narrow as the dollar continues its decline against most major currencies and China allows its currency, the Renminbi, to float versus the U.S. dollar (currently trading at a Chinese pegged exchange rate of about 8.27 to the U.S. dollar), giving Chinese citizens higher worldly wages and possibly reducing our standard of living as prices of goods produced there rise. So many changes are taking place that the much awaited floating of the Renminbi is inevitable.

## **Why Too Much Talk about China is Never Enough**

One such change is the treatment of intellectual property. I wish I could say it was out of kindness and respect for foreign intellectual property, but I can't. For years, foreign companies doing business in China have been complaining about the lack of intellectual property protection. Well, be careful what you ask for. You see, now that China has real budding entrepreneurs that are not only copying and manufacturing at lower costs, but innovating and even competing against each other, real intellectual property enforcement is close. As they continue to get burned by their own lax enforcement, they'll begin to see the value of broadly reforming intellectual property enforcement. Once they gain this piece of Global Trade credibility, further investment will be made and currencies will adjust further toward equilibrium.

I used to think China was going to take over this civilized world of ours through brutal economic (price) competition. Well, we have to face the reality that in the not so distant future China will be a significant military power, if not a “superpower”. With a standing army over five times that of the U.S., we have to be thinking about how the investment world is going to look with multiple superpowers. China's relative weakness to the U.S., for now, is technology. Through the use of some Russian technology (isn't that the combo of our dreams?), China is now in testing and soon to be in production of nuclear submarines capable of striking targets 7,500 miles away. The hope is that they are interested only in deterring the U.S. from defending Taiwan should China invade, but I think this is naïve. My thought process is not alarmist. I just want my clients to think in

a bigger scope than their own retirement and investing over a period longer than the next 5 years. If we as Americans are going to maintain our standard of living and preserve our wealth, we need to be thinking along the lines of (very) long-term asset preservation strategies, while we aggressively pursue the wonderful near term opportunities available.

Thanks to our independence, we can take advantage of a variety of economic scenarios. This year is looking to present us with some extraordinary opportunities on the investment front. If interest rates break out to the upside, we will have an opportunity to take advantage. If gold and oil stocks pull back to long-term support levels, another opportunity will present itself!! If stock market valuations finally get closer to and, better yet, overshoot their historical means, we will jump in wholeheartedly and participate in the great American stock market game once again while everyone else is telling you to stay away from that darned market! In the meantime, with asset preservation a priority, we are aggressively pursuing strategies to grow your real net worth.

Again, thank you for a great 2004! I'd like to wish each and every reader of this *Commentary* a safe, productive, and happy 2005.

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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