The CJ Investment Newsletter

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Freedom Also Means Freedom to Fail

Purpose

This is a reissue of previously disseminated information.

The *CJ* Investment Newsletter deals with the entire spectrum of securities investing, including cash (money market funds), bonds, equities and options. It will evaluate the overall investing environment and then discuss the relative allocations of these asset types, as well as strategies to implement within them. Essentially, it reflects what I'm actually doing with my clients.

These letters are not sent "cold." Either I know you or someone you know gave me your name. Yes, this letter *is* a sales tool. It communicates how I apply my investment strategies, so that you can decide, without any sales pressure, if my thinking is compatible with how you want your money invested. If you're not already a client, I would like to discuss your *becoming* a client. Please call me for more information.

However, that's not its only purpose. Even if you never become a client, if you want this information, I want you to have it – for a while, anyway. My hope is that providing this information and teaching you what I think is important when investing may help you. Please contact me if you have any questions or comments. I'd love to hear your reaction to my letter.

Quick Look

Market	**Next Expected Move**
?	**?**

- The stock markets had a major mid-month swoon, reaching an intraday 10% correction from the peak, and rallying since. Effectively, the markets have moved up slightly since last month.
- The Bernanke Fed made a creative move to help push liquidity into the debt markets experiencing the credit crunch. So far, he has avoided establishing the "Bernanke Put." However, the credit crunch is still unresolved.
- The US$ remains on a precipice. The markets wait to see if Bernanke will trash the US dollar to try to stave off a recession.
- Strangely, I haven't seen a flight to quality other than to US Treasuries. Gold & commodities are not rallying as I thought they would, yet.
- The contrarian view suggests that there are entirely too many officials and pundits telling us the market is fine and it's time to buy, buy, buy… If they're so good at picking market changes of direction, why weren't they telling us to sell, sell, sell at the top?

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"*The wavelike movement affecting the economic system, the recurrence of periods of boom which are followed by periods of depression(recession), is the unavoidable outcome of the attempts, repeated again and again, to lower the gross market rate of interest by means of credit expansion. There is no means of avoiding the final collapse of a boom expansion brought about by credit expansion. The alternative is only whether the crisis should come sooner as the result of a voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved.*"

Ludwig Von Mises, Human Action, Mises Institute, 1998.

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Capitalism Involves Failure, Too

Please reread the above statement by the incomparable Ludwig von Mises before continuing. Its perspective should be kept in mind when reading what follows. If you're a long-time reader, you'll know the Mises quote above has been used many times in this letter, perhaps not as regularly as it should have been.

Both Fed Chairman Ben Bernanke and President Bush gave speeches today. Both said it is ***not*** the government's responsibility to bail out those who are losing money because of real estate and credit crunch problems. Of course, Bernanke immediately suggested that the Fed stands ready to use whatever tools it has in order to keep the economy strong and from tipping into a recession. After making his statement, President Bush charged the Administration and Congress to come up with some ideas to keep "deserving" homeowners from losing their homes as the interest rates on their ARM's (Adjustable Rate Mortgages) increase beyond their abilities to pay them. No one knows what form this will take, but he specifically mentioned using the FHA. I forget if he mentioned Fannie Mae or Freddie Mac, but they would certainly be considered some of the "usual suspects."

Of course, these mortgages *MUST* have been sold by unscrupulous and overly aggressive mortgage lenders. *No one* who entered into these ridiculous loans could possibly have known what they were doing, nor should they be held responsible now. In the eyes of the government, we are almost all innocent, stupid dupes that were tricked into using these mortgages by sophisticated and evil businesses. There was *certainly* no demand created for these products by US citizens! How condescending and insulting to us!

Additionally, how is it possible to bail out the debtors without bailing out the creditors? I can't wait to see how *that* happens! What about all the investors who bought RMBS's, CDO's, CMO's and the like simply because they provided a better yield without considering the additional risk? These instruments are held in a lot of hedge funds, as well as 401(k)'s and other qualified plans. The fund managers and trustees made those investment decisions, but the investors and plan participants will pay the price. How much responsibility do the rating services (Moody's, S&P, D&B) bear for their high ratings of these instruments?

Of course, neither mentioned the complicity of the Fed or the government in creating the conditions that allowed these circumstances to happen in the first place. I'll remind you briefly of some relevant ideas:

- The business or trade cycle (periods of boom and bust) are *created* by a central bank (*e.g*. the Fed). Under Austrian economic theory, the expansions are created by artificially low interest rates and too-freely available credit. Capital is destroyed and jobs lost during the "bust" of the cycle, although when the entire cycle is done, there was more gain from the expansion than loss from the bust. This is not because the cycle is inherently good; it is because the normal workings of capitalism (below) tend to improve the overall condition of individuals and society. It is the underlying capitalist actions inside of and separate from the trade cycle that improves things.
- Capitalism has elements of Social Darwinism. As newer, more competitive products and cheaper methods of production are developed, older and less competitive products and methods are replaced. This results in the destruction of some or all of the old capital and is the source of the famous Schumpeterian phrase heard often and frequently misapplied: "gales of creative destruction." Often, the destruction includes the loss of many jobs, as automation and other productive efficiencies create less need for labor. This usually translates to cheaper prices and/or superior products to consumers.
- Part of capitalism as we experience it is the "free market." At least, it is *portrayed* as free by politicians and pundits. The markets are a vital mechanism for both creating capital (profits) and for insuring capital is moved to where it's needed by the economy. Like the economy and intimately connected to it, markets experience both expansion and bust. We call them bull and bear markets, respectively. As with the bust portion of the trade cycle, the bear portion of the market

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Asset Allocation Percentages
CJ Current Suggested Ranges

Dow Theory Market Phase: ??
Appropriate Current Allocation: DEFENSIVE

<u>**Asset Class**</u>	**Conser-** <u>**vative**</u>	**Aggres-** <u>**sive**</u>
Money Market Funds	70-10%	55- 5%
Long Positions:		
Bonds & Bond Funds	30-60%	40-60%
RD Stocks	0-10%	0-10%
Growth Stocks	0%	0%
Gold Equities/Funds	0-20%	10-30%
Bear Market Funds	0- 10%	5-20%
Aggressive Positions:		
Shorts and/or Options	0%	0- 5%

Notes:
Income generating portfolios may not conform to the above guidelines. If income is the primary purpose of a portfolio, income needs are met *first*, then other allocations are made.

Up to 50% of bond/bond fund positions should be in international (non-US) bonds. Such bonds will provide higher interest paid on the face due to the additional *perceived* risk of foreign bonds, as well as providing hedging gains as the dollar declines against foreign currencies due to Fed monetary policies.

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- cycle is a critical phase needed and used to wring out excesses and improper capital allocations. Afterwards, capital can then begin to flow to the "right" areas.

Unless I missed the headline, no one has yet found a way to repeal trade cycles or bear markets. Greenspan did his best, though. When Greenspan lowered the Fed funds rate to 1% and *supported it for years with outrageously free credit and money supply growth, he almost destroyed bonds as a meaningful way of earning investment returns*. That is why the derivative mortgage bonds were tranched and leveraged up and sold – to provide a decent interest/investment return. They were very attractive to investors. However, above-market return can't be created without additional risk. Somehow, the parties involved forgot or ignored that. Now they are going to relearn that lesson – painfully.

Perhaps Ed Easterling put it best, in his chapter in John Mauldin's <u>Just One Thing</u>: "*The implication is that risk creates returns – as though risk represents an element that mixes with investment capital to morph into returns. In reality, risk represents a condition that drives investors to demand compensation and protection. As a result, in the financial markets, higher returns tend to be associated with higher risks, which is far different than the notion that risk drives returns*." Obviously, higher risk also means that sometimes the risk is realized and loss on the investment occurs.

How "free" can our markets and economy be if they are constantly manipulated by our government? How can we call our system capitalism when some of the normal and necessary consequences of capitalism aren't allowed to happen? Once again, the trade cycle is not inherent in capitalism; it is inherent with an economy with a central bank that consistently tries to stimulate business growth through monetary stimuli. Capitalism can't work to improve our lives without the destruction of uncompetitive products and businesses, unproductive jobs and capital lost because of better products and ideas. Free market capitalism is not all success. Successes cause less competitive products and businesses to fail. Capital is lost. Entrepreneurs and other businesspeople who anticipate customer demand improperly lose capital, and sometimes their businesses. Without failure and loss, there is no capitalism. When the government interferes at this level, it can only be called a form of socialism.

The *ONLY* good reason for the government and Fed to become involved in the real estate and credit market problems now is *their complicity in creating these problems in the first place*. Unfortunately, the populist tools they intend to use are the very tools that brought the crises about in the first place. Regardless of their motivations, they should remember, "The path to Hell is paved with good intentions." Isn't it also true that, "Insanity is when you keep doing the same things and expect different results?" The "Greenspan Put" and his desire to repeal the business cycle brought us to this place. Bernanke probably knows this, and has resisted (somewhat) recreating the conditions that will only prolong, not correct the situation we're in – so far. Some form of government bailout for homeowners who might be able to make it with minimal help might be appropriate, since the government is somewhat responsible. We all have to learn, though, that in order to be free to succeed, we also have to be free to fail – and suffer the consequences (good and bad) of our actions.