



The Centurion Counselor

First Quarter 2009

UNDERVALUED SECTORS (CONSIDER!)

- CONSUMER DEFENSIVE
- MEDICAL DEVICES
- MEDICAL DIAGNOSTICS
- REGIONAL BANKS

OVERVALUED SECTORS (AVOID!)

- JUNK BONDS
- EMERGING MARKETS
- TREASURIES
- BIG BOX RETAIL

Mark-To-Market

There are so many people to thank for the current economic crisis that it is hard to find a place to start. We could blame Congress, Wall Street greed, the Federal Reserve, overleveraged consumers, stupid bankers, the Bush Administration, “Tiny” Tim Geithner and even bad luck. However, we are reserving a special thank you, to FASB (Financial Accounting Standards Board). This little-known group whose mission statement is “Serving the investing public through transparent information resulting from high-quality financial reporting standards, developed in independent private-sector, open due process.” Thank you for turning what would have been a bad, deleveraging-driven economic downturn into the borderline depression here in the U.S.

Thank you, for sticking to your guns, even in the face of overwhelming evidence that you were wrong. In an apparent face-saving move, they relaxed the standards a little. Let’s take a minute to explain what happened to the banks and the credit markets because of FASB. As they say, the road to hell is paved with good intentions and the mark-to-market rule is no exception. FASB put the mark-to-market rule in effect November 2007 (Dow 13,930) to make financial institutions mark-to-market all of their assets, even if they were not planning on selling them. That sounds good on the surface as banks could not overvalue loans on the balance sheets. It also assumed that all markets are liquid and efficient.

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Let us give a real life example of the unintended consequences of this action. I have a friend JOE who is self-employed (1099 income) and makes between \$150,000 and \$400,000 every year. He is a sub-prime borrower because he is: a) self-employed, b) has a jumbo loan and c) was late on two mortgage payments before he got his new loan (2006). Joe purchased a new home in late 2006 for \$700,000 (I never said his timing was good) and put down 20% or \$140,000. He has since invested over \$150,000 in remodeling the home, and has never missed a payment or been late.

As a California sub-prime borrower, he is lumped in with all of the other California sub-prime borrowers that you have read about. These loans sell for between 20 and 40 cents on the dollar. This means that the bank holding Joe's loan has had to write it down in value to between \$110,000 and \$220,000- a loss of between two and three hundred thousand. If Joe were to refinance his current loan, the lender would then realize a gain and the new lender would have an immediate loss. As a result, poor Joe cannot get a new loan. In the old days, when Jimmy Stewart ran the local savings and loan, he would have looked Joe in the eye, decided that he was a good credit, and may have reserved a few dollars against the chance that Joe's loan would turn bad. Today, under the FASB reign of terror, that is not possible!

That is the problem-there are tens of thousands of average "Joe's" with the same dilemma: they will make their payments, but the banks must take losses today that common sense says will never be realized. The headlines April 2nd stated that mark-to-market was being eased; however, the rules still state that banks can only accrete any gains they experience. This means that any gain in value on the banks' books will be recognized on a pro-rata basis over the life of the loan.

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Let GM Go

GM (General Motors aka Government Motors) has been insolvent for years...to the surprise of no one. Why then is the Black Hole of General Motors allowed to grow? Our country was founded on a system that rewards success and punishes failure. It seems now that failure is not allowed. This is business and taxpayer's money, not some t-ball game where there are no losers and everyone gets a trophy for participating!!

It is easy to blame the unions who have blocked efforts to bring the company's cost structure into line with changing economic realities. We could blame Congress for changing rules and meddling with fuel efficiency standards. However, the real culprit is management, whose years of bad choices have now left the U.S. government with a terrible choice – whether to give GM billions of dollars of money inside or outside of bankruptcy. The correct decision, as unpalatable as it may be, is painfully obvious. All the king's horses and all of the king's men are not going to be able put GM back together again. As bad as it may feel, it is time to let this American icon join other icons of yesterday such as Polaroid and Pan Am, declare bankruptcy, and get out of the way.

It now appears that Washington will give GM the “good sport” trophy while cramming down the holders of more than \$40 billion of debt. Instead of wasting time haggling with debt holders over exchanging a portion of their worthless debt for worthless stock, the company should declare bankruptcy so these bonds can be wiped out. The reality is that they made a bad investment and should suffer the consequences. We need to stop trying to save everyone from the consequences of their errors or else they will keep making them.

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Let GM Go (continued)

We are afraid that under the guise of union givebacks they will be given a significant ownership role in the new GM. Washington will negotiate exchanging at least one-half of approximately \$20 billion of Voluntary Employee Benefit Association (VEBA) obligations into equity. Unfortunately, 100% of the VEBA obligations in the real world are worthless, since GM would never be able to pay them without taxpayers help. In a bankruptcy, the workers would not receive any more than what can be granted in bankruptcy, which is likely a meaningful equity stake in exchange for the VEBA and the billions of dollars of other healthcare and pension obligations owed to current and retired workers. This is one of the hidden goals of universal health care which could move billions and billions of dollars off the books of companies with union contracts and onto the backs of taxpayers. The shareholders and management have already been all but wiped out and we are sure that the next 60 days will finish the job. We are not advocating throwing on to the street all GM workers, but they do not deserve any better treatment than any other worker who loses his job. Allowing GM to file for bankruptcy will be a blow to the American psyche. But GM has already gone bankrupt in all but name; by putting off the hard choices, we will enter a Black Hole of liabilities.

Looking for more info on the markets?

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receive our weekly market review.**

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