



The Centurion Counselor

Second Quarter 2008

UNDERVALUED SECTORS (CONSIDER!)

- MEDIA
- CONSUMER DEFENSIVE
- MEDICAL DEVICES
- MEDICAL DIAGNOSTICS
- LARGE CAP PHARMACEUTICALS



Speed Kills

OVERVALUED SECTORS (AVOID!)

- JUNK BONDS
- EMERGING MARKETS
- MONEY CENTER BANKS
- REITS

If one has the propensity to drive fast, resulting in speeding tickets, there is a greater chance that one would also engage in dangerous investing behavior as well.

The study, *Sensation Seeking, Overconfidence and Trading Activity* (Mark S. Grinblatt and Matti Keloharju, *The Journal of Finance*), found that there was a correlation between speeding tickets and trading frequency. Why? Two of the several reasons are: 1) If a driver deludes himself into thinking that he can avoid being caught while speeding, he may also be deceived into believing he has above-average stock-picking abilities. 2) There is a direct correlation between speeding tickets and thrill seeking. The study concluded that there are those who look for a new and risky experience just for “the fun of it.” They feel that they can beat the market and that a static portfolio is too boring.

Sticking with investments, but changing sectors, we have experienced by almost-historical margins, the same thrill-seeking behavior in real estate. *The Wall Street Journal*, on February 6, 2008, reported an extraordinary number of buyers who lied on their applications by misstating income, job history, and that they would, in fact, occupy the property being acquired. Within as few as 12 months, defaults occurred—uncovering the fact that a great percentage of these homes were never occupied by the buyers.

The chaos in the housing market has temporarily taken the fun out of thrill seeking—however, not temporarily enough in our opinion. Reports indicate that people are losing their homes in record numbers; and, as a result, must relocate to a new dwelling place. This, of course, begs the question: “Won’t this be good news for apartments?”

Great question! We are frequently asked by investors if they should invest in apartments. But . . . not yet! We believe the future will be wrought with “deep-discount” opportunities, but buying now would be premature. However, the ground work is being laid.

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Page 1

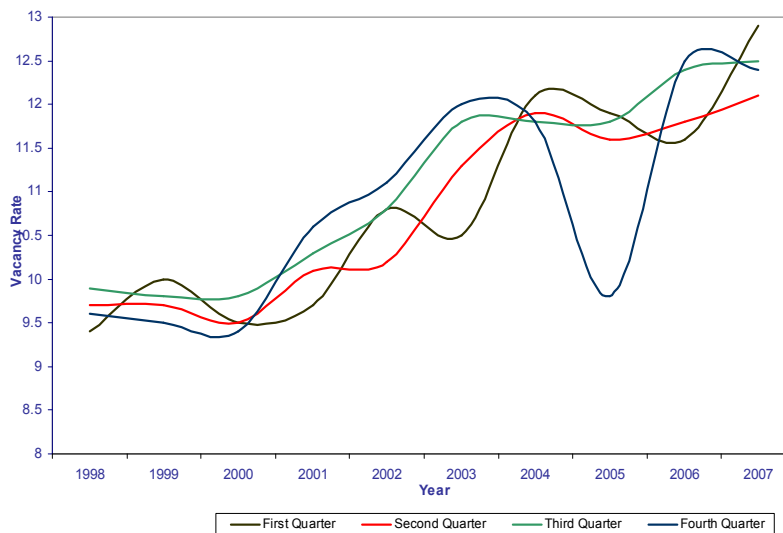


Speed Kills (continued)

Why is this? Simple supply and demand! It's a battle between the owners of houses or condos—whether individually or bank owned—and the owners of apartment buildings. Currently, thousands of houses and condos are either vacant or in foreclosure with desperate speculators and lenders turning them into rental units and screaming “Come rent from me!” Apartment owners are bowing to potential renters by offering rent concessions, or incentives, in order to raise occupancy. Under that plan, occupancy will rise but rental income will decline; therefore, making rental increases impossible and future value questionable. At this point, renters are the winners.

As the chart below indicates, vacancies are growing. This makes it more difficult for landlords to raise rents.

Vacancy Rate by Quarter



Here is the key to why it's different this time. Over the past five years, builders and developers have been building at a frenzied pace. The end result has created an overbuilding and increased rental competition in the single-family home arena, particularly condos—the rental choice in favor of apartments—dispelling the notion that now is the time to be buying apartments.

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Page 2



Speed Kills (continued)

Furthermore, class "A" apartment building rents are currently flat; and, as rents flatten and even decline, it will put pressure on all apartment rents as well as their future hoped-for-values.

One last thought: In the past, there were the homeowners and the apartment renters. Today, homeowners have been foreclosed upon, causing them to become today's new renters. Given a choice, would one choose a three-bedroom, two and one-half bath home with private yard, three-car garage and plenty of storage . . . or, a two bedroom, one and a half bath apartment, no private space, one-car garage, and with limited or no storage requiring additional rent for a storage unit?

The Greatest Threat to the U.S. Economy?

No, it's not Freddie Mac, Fannie Mae, inflation, deflation, Republicans, Democrats or Social Security. It is Medicare. Current estimates are that the Social Security System will run out of money in 2041. According to numerous articles, sometime late in the next President's first administration Medicare part A will go negative, with the entire system going broke in 2019. The program has already begun paying out more than it receives in payroll taxes. And the trustees now forecast that its trust fund will be depleted by 2019 (vs. 2018 a year ago), at which point Medicare would only be able to pay out 79 percent of expected expenditures. The Social Security trust fund is projected to become exhausted in 2041, but the public health system runs completely dry much sooner. It is estimated that to bring Social Security into balance over the next 75 years would require a 15 percent increase in payroll taxes today (or a corresponding reduction in benefits). Bringing Medicare into balance would require, that payroll taxes, over the next seventy-five years would need to increase by 3.55 percentage points, on top of the 2.9 percent of all wages that is paid by workers (who pay half) and their employers (who pay the other half). That would bring the Medicare taxes to 6.45 percent of all wages. This is on top of any increases for social security, income or other health care plans to be enacted.

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Page 3



The Greatest Threat (continued)

Medicare was designed to be funded by three sources: payroll taxes; Medicare premiums (paid by Medicare beneficiaries); and general revenue (typically money from income taxes). Even more significant, the present underfunding of Medicare (\$34.7 trillion) is more than eight times that of Social Security (\$4 trillion). To give the numbers a little more immediate flavor the financial markets are in an uproar over the 7 trillion that Fannie and Freddie may owe.

Few leaders in either party seem willing to face the fact that Medicare is a structurally broken system that could bring the American economy to its knees in a relatively short amount of time. As accumulating evidence makes abundantly clear, Medicare is not just an undercapitalized system but a severely flawed model. One of its biggest defects is the inherent mismatch between revenues and expenditures. Because they are tied to the rate of business growth, payroll revenues have proven to be woefully insufficient, particularly in economically stressed times such as the past few years.

What must be done? First of all, just as with Social Security let's get rid of the idea of trust funds. There are no monies set aside to cover any future expenditure. Congress has for years spent all of that money to pay for current pet projects. Secondly someone has to take the lead and while you may not agree with all that Rep. Paul Ryan is proposing we believe that it is a good start. As Rep. Ryan stated "The entitlement crisis facing our future is not a Democratic problem or a Republican problem. It is a problem facing all Americans, and as a result, it requires bipartisan dialogue to advance a solution." We have included the link to <http://www.americanroadmap.org/> which has Rep. Ryan comprehensive proposal. We believe it is well worth your time.

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Page 4