



# The Centurion Counselor

Third Quarter 2008

## UNDERVALUED SECTORS (CONSIDER!)

- MEDIA
- CONSUMER DEFENSIVE
- MEDICAL DEVICES
- MEDICAL DIAGNOSTICS

## OVERVALUED SECTORS (AVOID!)

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

## **THERE IS NO SUCH THING AS A FREE CRUNCH**

Today is much like 1982, when every major US bank thought it was a good idea to loan lots of money to Latin American countries. It was a most profitable business, right up until the countries decided to default. Then every US bank was more than just technically bankrupt. In a mark-to-market world, every large US bank would have collapsed. It would have been the end of the financial world as we knew it.

What did they do? The Fed let the banks keep the loans on their books at face value. Over time, they worked their way through the debt, making enough money to be able to write down the loans.

That was done simply to give the banks the ability to buy time. We are in a very similar situation. We have to buy some time in order for financial institutions to heal. This type of crisis comes along every eight years or so. A new crop of MBA's get out of school stuffed with theory but no real experience in pricing risk. They proceed to make lots of money then blow themselves and almost everyone else up. This has happened at least five times in the thirty-nine years we have been in the market.

The article below could have been written today but it appeared two years ago in the October 2006 Counselor under the title "Too Smart For Their Own Good". It is with some pride that we can say we told you so but we would prefer to have not had this happen and to have avoided the pain.

*The 3<sup>rd</sup> quarter ended with the news that a large hedge fund had been on the wrong side of some natural gas trades and investors lost at least \$6 billion. While all of the news is not yet clear, it appears that most of the funds' bets were in over-the-counter derivatives. It may be easy to dismiss such losses as happening only to the super-wealthy, but this is often not the case. In an effort to chase returns (more on this later), many state and local government pension plans are investing in hedge funds. More often than not, they have neither a clue what the fund invests in, nor, most importantly the high leverage used. The use of derivatives has grown rapidly in the last several years.*

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*Derivatives represent financial innovation and, when used properly, are a flexible and efficient way for investors and corporations to reduce risks while giving themselves the opportunity to maximize returns. However, it is the over-the counter (OTC) market where excesses are appearing. It is estimated that nearly \$50 trillion in OTC derivatives will be traded this year versus almost zero five years ago. Investing in derivatives has been one of the biggest growth industries in recent years. Speculators gamble on whether companies will go bust, which way interest rates will go, or the future price of commodities, equities or bonds. Even pension funds have been pouring money into derivatives to take advantage of rising prices of industrial and precious metals. With these commodities having fallen recently, many of these pensions such as Amaranth Advisors have been left with little other than burned fingers.*

*These instruments have become a significant source of earnings for both major money center banks and investment firms. The contracts are not cleared electronically, resulting in an imprecise risk picture. This occurs because each contract could be traded several times with the original issuer not knowing who the current holder is. For example, a bank might buy credit-default protection on General Motors from a first-rate hedge fund, which can then trade the contract to a smaller fund with inferior credit. This would occur because a bank or insurance company may own \$20 million of the GM bonds. "Lay-off" is a betting term. When used in the context of investing, it is a procedure which allows a bank to lay-off part or all of the GM default risk to another party, usually a hedge fund or a high yield mutual fund. At this point, the bank believes that it is risk-free. We believe that is not the case, but in fact the bank's risk has increased because it added a party to the original agreement between itself and GM. Now they have to worry not only about GM, but also worry about the ability of the hedge fund to make good in the event of a default.*

*Several months ago, the total sum of GM credit default swaps exceeded the total of GM debt outstanding. A default by GM or any of several other companies will cause a substantial test for complex credit-derivative products, many of which involve leverage, or borrowed money. Thus, small moves in the value of an underlying security can have a big impact on the value of such credit derivatives. Since these aren't listed on any market, closing out a position can be very costly, as Amaranth recently found out.*

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## **THERE IS NO SUCH THING AS A FREE CRUNCH (continued)**

*What would happen if this spread and several hedge funds failed? It could be the nightmare scenario everybody hopes will never happen: a financial crash, affecting us for years to come.*

*Regulatory bodies in Europe and the US appear to be getting twitchy about areas where there is less transparency than in the comparatively simple business of trading shares via brokers and banks. They are calling for global collaboration to regulate the derivatives industry and have issued warnings and a flurry of consultative documents designed to allay fears about an impending crisis, or at least to counter any perception that they are not monitoring developments closely.*

*As Bob Dylan said two decades ago, "The Times They Are A-Changin'." Interest rates are going up and there are fears about a slowdown, at best; and a recession, at worst. And, as always, when the economy shifts down a gear or two, worries turn on the issue of debt. A big corporate default here, another one there, could have disastrous consequences, especially as exposure to debt is spread wider than ever before.*

Of course, they did not regulate anything and this being an election year finger pointing is rampant. We believe that we are currently in the eye of the hurricane, the worst has passed but soon there will be more storms and strong buffeting. Companies that used too much leverage or financed their growth with short-term debt (ie. leasing companies) will have hard times ahead. We believe that a global depression has been avoided, but the price for avoiding it will be a short very steep recession. The good and bad news is that the consumer will save more. This is good because savings have been near zero for much of the past twenty years as homeowners' have used their houses as piggy-banks. They will now be forced to save for retirement. It is also bad for the economy because the consumer who has been the backbone of this economy will be missing in action. This spells bad news to come on credit card and auto debt.

Governments the world over have sent elf's into the basement of their treasury departments and they have been busy printing Dollars, Yen, Pounds and Euro's. This will hinder governments from embarking on major new social programs as they attempt to repair their balance sheets. Taxes will rise and in Europe we may even see some undoing of social programs. The United States has

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caught a bad cold but we are afraid that some of the emerging countries such as Russia and China will end up with pneumonia.

Growth will be slower in the future without the turbo charging effect of high leverage and the consumer, but the economy will grow again, most likely again in late 2009. It is important to remember that equity markets anticipate the future and may have already put in their lows. If Washington avoids the temptation to over tax, regulate or otherwise strangle the economy the “sun will come up tomorrow. As the savings rate increases monies will flow into the equity market.



Effective November 10, 2008 our address will be:

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*All email addresses, phone and fax numbers will remain the same.*

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