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INVESTMENT POLICY MEMO

Since our last commentary stock markets around the world have advanced moderately, while the portfolios that we manage have, for the most part, advanced minutely. Our portfolios were solidly constructed to withstand unexpected inflation or political/terrorist calamities. In the absence of anything remotely like this, the portfolios stood strong, like the Maginot line, while the rising market tide began to flow around them. For about a year now, our clients have lagged stock market results because we have protected them against bad things that never happened.

One man who did call it right was Federal Reserve Chairman Ben Bernanke. In his June testimony to Congress he predicted that oil prices would ease because of slowing growth and that inflation would ease for the same reason and because of falling oil prices. This is exactly what has happened in the last three months. Bernanke also forecast, as we had, that the contraction of housing would cause a slowdown in economic growth but not an economic recession. The question we raised in our last Memo about whether growth of the U.S. economy and pressure on its resources would lead to inflation or prices would continue to be contained by the forces of globalization, has now pretty much been answered in favor of globalization. The decreased demand for oil caused by high prices also has played an important role.

As we have said many times, slow but continuing growth, low inflation and low interest rates are a launching pad for markets to the moon. While markets have definitely achieved lift off, they are still a long way from the moon, and a decent capital gain away from fair value. All of which is not to say that there are not still frightening risks looming on all horizons and disconcerting uncertainties about what an increasingly large collection of autocratic terrorists from our President to Bin Laden might decide to do. This is one reason why we are already approaching fair value for stocks although they are roughly where they were seven years ago when earnings and dividends were quite less than today's levels.

If we had started this Memo, as we usually do, with a recitation of the spreading examples of greed, corruption, violence and reckless empire building that engulf the world we might never have gotten to these investment conclusions and we might never have been able to persuade you they were reasonable. It is emotionally difficult to reconcile the manifest growth of evil with the idea that securities could be a good investment.

War is raging and thousands of American servicemen and women have died, along with an unknown number of mercenary "contractors". American civilians died in hijacked planes and targeted buildings on 9/11, and since then civilians have died in terrorist attacks around the globe. Still, the obvious truth is that we are in far less danger from the rest of the world than the rest of the world is from us. From Fallujah to Kandahar we have already taken thirty to sixty innocent lives for every one of ours lost to terrorists, not one of whom was from Iraq or Afghanistan. In Darfur we do our careful dance of avoidance while genocide rages. In Lebanon a mere hundred or so civilians are killed and a mere \$4 or \$5 billion dollars of destruction is the

price of a country's destroyed infrastructure. Aid will be a long time coming, as we are busy spending this much every two weeks on destruction in Iraq and Afghanistan; and borrowing this much from the rest of the world every 36 hours to cram more stuff into our bloated consumers and more weapons into our stuffed goose of a Pentagon. And we remain determined along with the EU to punish Lebanon and Palestine for electing and tolerating Hezbollah and Hamas.

Every once in a while the press takes note of the asynchronous rhythm of Wall Street and Main Street. When growth and wages are low and unemployment is high on Main Street, Wall Street is often at its best. Although the reasons, if any, are not obvious, the same could be said for the relation between Wall Street and the "War on Terror". The ascent of the stock market coincides almost exactly with the Invasion of Iraq and with the increasing violence and chaos ever since. This has surprised us more than once over the past three and one-half years. We could be forgiven for thinking that large domestic and foreign deficits, less spending on public health, education and public safety, increased risks of terrorist attacks, a policy of willful destruction of international treaties governing war and nuclear weapons and of willful destruction of the environment coupled with increased dependence on imported oil and gasoline, might be considered bad news for the stock market. In fact, rapidly rising profits were the good news of the moment and all the rest was no more bad news than low wages or rising unemployment would have been.

Indeed the global market reversals of May and June were driven by a fear that wages had increased at a double-digit rate in the first quarter (good Heavens!) adding to inflation fears at the time. The markets indicated their relief from these fears partly after they were addressed by Ben Bernanke's testimony and partly after it was shown that the large reported increase in labor costs in the first quarter of the year wasn't as bad as it looked. Why? Because it was not caused by an increase in the hourly wages of most working people, whose real compensation continues to languish far below the levels of three or four decades ago. This was a benign increase in labor costs, caused by huge increases in the bonuses and stock options of top executives, particularly on Wall Street, whose total compensation was divided by the hours they were presumed to work.

The ideology of this analysis is clear; but the economics are murky. If all the CEOs in America engineer bonuses for themselves and their closest cohorts that equal about two percent of America's total private labor costs per year doesn't somebody have to pay for it? It is curious that Wall Street doesn't think so. If the increased labor cost of CEOs is not paid for by higher prices, then it has to be paid for by lower profits to stockholders. It is a testimony to Wall Street's expertise in obfuscating the truth, that it has succeeded in hiding this simple fact even from itself.

There is a visible progression all around us toward empire, plutocracy, immoral violence and immoral neglect. It is symptomatic of how far along this road we have traveled that so few public voices speak of it clearly. Who indeed in the entire U.S. Congress other than Senator Robert Byrd and Representative Dennis Kucinich? Our would-be emperor complains that the Geneva Convention is "vague" when it demands respect for the dignity of every human being. Our virtuous Ciceros in the Senate -- McCain, Warner and Graham -- express their horror at abandoning a code of conduct that protects Americans as well, and then, after a few days of photo-ops, they agree essentially to "clarifying" the kinds of torture that may be used without

fear of reprimand or punishment from any quarter and the kinds of people on whom it may be used. The clarifications are classified top secret.

It is natural to imagine that all of this evil and excess will inevitably lead to a terrible calamity for the United States. However, as we have pointed out before, the Roman Republic endured a century of blood-letting, betrayal and corruption, before finally proclaiming that it was an Empire. And the Empire lasted another 500 years after that, perhaps longer than the life span of any republic in world history. Yes, we have turned Afghanistan into the supplier of ninety percent of the world's opium; and yes we have made Iraq a nightmare for everyone who lives or fights there; and yes we have been the primary promoter in the world of nuclear proliferation; and yes this list could go on forever. However, none of these things, not even the foreign trade imbalance, is likely to cause an imminent, severe crisis. Since the Great Depression, people who seek more peace and justice in the world have carried the romantic notion that the excesses of our system would inevitably lead to another economic crisis, which, by implication, would lead to more enlightened public policies. Such a crisis is highly unlikely, not to mention that in the actual event the Depression of the 1920's and 1930's produced more evil changes in governments than virtuous ones.

So we are left with the question of how to invest your money if neither the end of the world nor a financial crisis is imminent. As already noted, given that powerful forces are channeling the U.S. and world economies toward steady growth with low inflation, the simple answer is to buy equities. Within equities our emphasis is on large, global, profitable companies. They will benefit most from a falling dollar and from stronger growth overseas than at home. They are also inexpensive relative to smaller companies and relative to their past histories.

The industries we favor are: consumer staples and healthcare, whose steady growth rates will look better as the economy slows; providers of goods and services to the growing stream of investment by corporations; and energy stocks, which we still believe have high long-term growth prospects because of the increasing scarcity of oil and gas. In the near term, energy stocks are likely to do poorly as economic growth slows and the demand for energy falls with it. However, they are a uniquely good insurance policy against a variety of possible military, political and terrorist events.

Despite these inclinations, our portfolios are more broadly diversified among sectors and industries than has recently been the case. We have also moved more money into U.S. stocks and a higher proportion of the remaining international investments into Europe and Japan. As we are reducing the overall cash positions in most accounts, we believe these changes in the composition of stock holdings have enabled our managed portfolios to remain reasonably safe.