



CAUTION: DANGER AHEAD

Speech to Institute for Private Investors

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Thank you for having me today; it is a pleasure and an honor to be here. My goal is to shed light on some key economic trends and their potential effects on the financial markets and then briefly discuss how we are positioned in the products I formerly managed.

Initially, the suggested title for my talk was, “The ‘First’ Pessimist’s View of Today’s Markets,” while last year’s *Fortune* magazine interview with me was titled, “The Man Who Sees Disasters.” These sound pretty negative. Rather than being a pessimist or disaster monger, I prefer to view myself as a realist. My conclusions are based on extensive critical thinking and evaluation. Accordingly, I decided to title my talk, “**CAUTION: DANGER AHEAD,**” because of the risks I perceive.

Before discussing these risks, I would like to share three lessons I learned early in my 41 year investment career that have served me well. I feel they have helped prepare me for these uncertain times.

1. Being overly optimistic can be harmful to one’s pocket book
2. Understanding the concept, “the Margin of Safety,” and the value of historical awareness in protecting capital.
3. Discovering and internalizing the idea of what I termed, “the investor delay recognition period.”

In 1971, I entered the investment field bright-eyed, optimistic and self-confident, believing that high investment returns were to be expected. It didn’t take long for me to realize how mistaken I was. My inexperience prevented me from understanding the nature and significance of the demise of the Bretton Woods accord that year, which ushered in the era of floating exchange rates, and the importance of the 1973 oil embargo. These were structural-change events that were initially misdiagnosed or misunderstood by investors in general and led to international trade instability, higher inflation and weaker corporate profits. When the equity market subsequently collapsed in 1974, I learned what it truly felt like to lose money and be fearful. Fortunately, the events of that year drove me to investigate and discover why this unfortunate outcome had occurred. I found Graham & Dodd’s 1934 edition of *Security Analysis* in which the authors extolled the virtues of investing with a “margin of safety.” Additionally, I met Charlie Munger in my USC graduate school investment class and had the opportunity to ask him this important question, “If I could do one thing to make myself a better investment professional, what would it be? He answered, “Read history! Read history! Read history!” This was among the best pieces of advice I ever received.

My investment education was further enhanced by the events that led to a dramatic rise in interest rates between 1979 and 1981. By 1979, the ten-year Treasury bond’s real yield had become negative,

and that was after four years of negligible compensation for the level and rate of increase in inflation. Newly appointed Fed Chairman Paul Volker, for whom I have great respect, initiated an aggressive attack on inflation by rapidly raising the Fed Funds rate. The stock and bond markets were slow to respond to this important policy change. This led me to the realization that most investors, faced with structural changes, experienced a delay in their recognition and understanding of the implications of these changes—“the investor delay recognition period.” This is why I constantly admonish investors to beware of following the crowd. You have to do your own thinking and reach independent conclusions. Recognizing structural changes may mean that both strategic and tactical adjustments in the management of money are required. Implementing these changes can be a risky business strategy. If one anticipates events or trends too far ahead of the general consensus, the prospect of underperforming the market and losing clients is all too likely. I can attest to this from my own personal experience, since by the time I was proven correct, I had suffered significant client defections. As John Maynard Keynes wrote, “Worldly wisdom teaches it is better for reputation to fail conventionally than to succeed unconventionally.” I cannot subscribe to such an expedient philosophy because of personal ethics and dedication.

These lessons helped equip me for the events and challenges to come.

1998 was a seminal year for me since it is when I came to realize that macro event thinking was taking on far more importance in my strategic investment thinking. In March, I argued that holding a high cash level would not be detrimental to long-term investment performance.¹ Instead, it would provide downside asset protection and flexibility. This view was completely out of sync with the norms of the investment management industry and was of great concern to my clients and shareholders. It was a radical change in my investment strategy, after 14 years of averaging between 1% and 3% liquidity, a period in which I would not have been labeled as being a perennial pessimist or worse. From March 31, 1998 to year-end 2009, when I stepped down from active money management, a 3-month Treasury bill achieved a 3.1% annual total return while the S&P 500 and the Russell 2000 returned 1.9% and 2.6%, respectively. The Russell barely beat the CPI’s 2.5% average inflation rate. The FPA Capital Fund, my equity fund, attained an 8.2% return, with considerably less risk than the market indexes, since liquidity averaged more than 25%, with an ultimate peak of 45% in 2007.

I battened down the hatches and prepared the portfolios for each of the greatest investment bubbles of our time: the 2000 stock market bust and the credit collapse beginning 2007. I wrote and spoke frequently about the coming dangers of each, but with little impact. Chairman Greenspan’s unwise monetary policy, between 2001 and 2003, was quite disturbing to me. I viewed it as foolish because it might trigger another bubble, possibly in real estate, which could prove to be larger in size and more harmful than the bursting of the recent stock market bubble. Dr. Kurt Richebacher’s economic letters, to which I had been a subscriber for years, first warned of this possible outcome since he was extremely critical and fearful of the Fed’s easy monetary policy. His thinking was grounded in the Austrian school of economics. Paul Volker said in 1982, “Sometimes I think it’s the job of each Fed chairman to try to prove Richebacher wrong.”²

Dangerous credit trends began to appear in 2005. I believed a major credit bubble was emerging and that precautionary actions were warranted. Because my skepticism was so deep, it led to my having a nightmare in early 2006 that was captured in the prologue to Roger Lowenstein's book, *The End of Wall Street*. I imagined Fannie Mae and Freddie Mac had filed for bankruptcy. The dream was so vivid and compelling that it helped to solidify my analytical thinking about the credit bubble. The following morning, after consulting with legal counsel on the implications of a bankruptcy filing, we liquidated all corporate debt holdings in both companies, representing approximately 40% of our fixed income assets. It was dawning on me that a potential tectonic shift was in the process of taking place in the U.S. capital markets. Thus began one of the most difficult, but also most rewarding, strategic shifts I ever made in my career.

By the spring of 2008, the unfolding financial crisis impacted me so profoundly, I wrote in my commentary, "Crossing the Rubicon," that, "...a new financial system is in the process of being created. This is the beginning of a new era."³ It was a warning of the dangers to come. That fall, the potential of accelerated Treasury debt growth captured my attention. I estimated that it would rise to between \$14.6 and \$16.6 trillion, by year-end 2011, from \$10 trillion. Once again, my conclusion was viewed by many as being too dour, rather than realistic, which it was proven to be since total U.S. debt stood at \$15.2 trillion at year-end 2011.

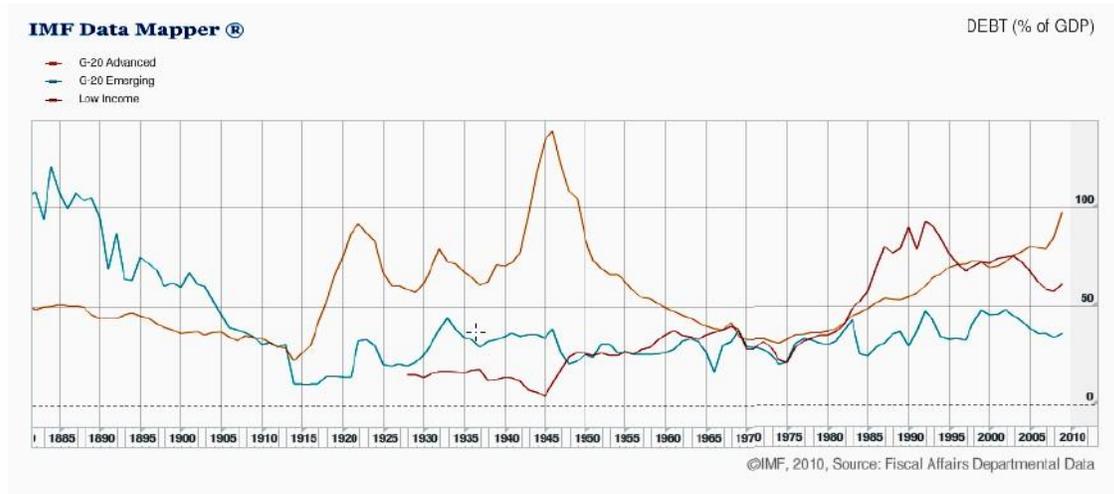
I hope that this brief historical review of my career should help allay fears that what follows does not come from the likes of a perennial pessimist and doomsayer. Neither does "**CAUTION: DANGER AHEAD**" spring from recent capital market volatility. Oh, No! When I left to take my sabbatical for a year in 2010, I conveyed to my associates and clients that the current crisis was only Phase 1, and the coming year would prove to be simply an interlude. If the nation's unsound fiscal policies persisted, within 3 to 7 years, it would face another financial crisis of equal or greater magnitude, and it would emanate from the federal level. I wish I had said sovereign level, covering all my bases, but I did not arrive at this conclusion until once away on sabbatical when my attention and thinking shifted to the international area--European sovereign debt in particular.

Phase 2 is now beginning and I think we are on the cusp of a decade of extreme economic and financial market turbulence. Uncertainty as to the effects of high system wide financial leverage and the outcome of the battle to determine what the proper role and magnitude of government should be within an economy are key elements in this future turmoil.

My first two exhibits help portray the magnitude and growth in global debt.

EXHIBIT 1

Debt-to-GDP Ratios Across Country Groups, 1880–2009
(Group PPPGDP-weighted average, in percent of GDP)



Source: HPDD.

Exhibit 1 above shows worldwide government Debt-to-GDP ratios from 1880 to 2009. This was a monumental undertaking by the authors, given the difficulty of gathering the data for their IMF working paper.⁴ Among the advanced G-20 countries, the top line, debt levels are at their highest, except for WW2, at nearly 100%. Their conclusion was that fast growing countries consistently registered low debt ratios while slower growers carried the highest ratios. The research by Professors Carmen Reinhart and Kenneth Rogoff demonstrates that once public debt is greater than 90%, it begins to retard economic growth and they observed, “...government debt is far more often the unifying problem across the wide range of financial crises we examine.”⁵ The implications of Exhibit 1 are disquieting.

EXHIBIT 2

A Tale of Two Crises: The Great Depression (1932) And the Global Financial Crises (2009) (Color-coding represents debt –to-GDP ratios)

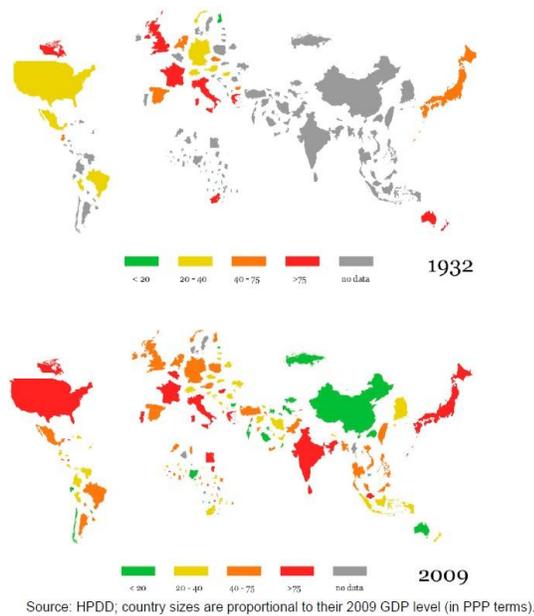


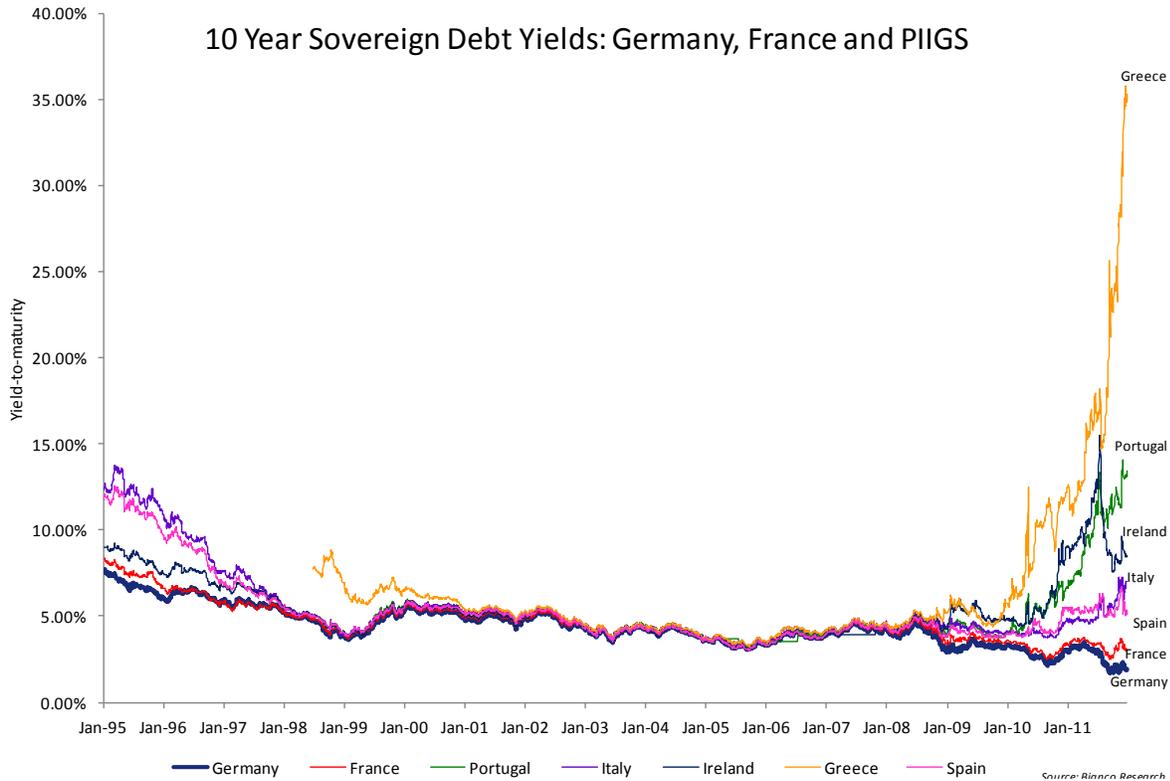
Exhibit 2 displays a debt heat-map comparing 2009 to 1932.⁶ It indicates that the current crisis for public debt appears to be more widespread and serious than that of 1932 but aggressive central bank monetary easing, during the last crisis, helped contain this risk thus far.

I will focus on three regions that account for 57% of global GDP which I refer to as the trio of fiscal misfits: the European Union (EU), Japan and the United States.

The EU and its euro-zone sovereign debt crisis are consistently front page news. Euro-zone countries France, Italy and Spain have total debt to GDP ratios in excess of 300% and are coming under greater scrutiny by the capital markets. Greece, much like U.S. subprime before the last credit crisis, is the canary in the coal mine warning of the fundamental issues facing the Euro. It should never have been allowed entry into the euro-zone since, “From 1800 until after World War 2, Greece found itself virtually in continual default.”⁷ Current debt restructuring negotiations will achieve little unless government, social entitlements and the country’s tax system are fundamentally reformed. Given that more austerity measures will be required, I do not expect long-term success and, thus, Greece will likely be forced to exit the Euro.

There is widespread debate as to whether the Euro will unravel. In my opinion, if one looks at comparative interest rates, it already has. Exhibit 3 on the following page provides a long-term interest rate view of selected euro-zone countries. What is obvious is that there were substantial interest cost benefits for countries converting to the Euro, particularly for Greece, Italy, Portugal and Spain, for whom lower rates became possible. (Note left side of chart)

EXHIBIT 3



Each of the euro-zone countries brought their sovereign finances into proximity of one another and then committed to various macro-prudential fiscal control measures, but they retained their individual sovereignty when the key to success was economic convergence. This remains a fascinating experiment for which we have no historical equivalent.

At the Euro's inception, my analysis of it was somewhat superficial since my thinking was U.S. centric. However, a 25% decline in the Euro's dollar exchange rate between 1999 and 2002 caught my attention. Selected investments were made but the coalescing of yields within proximity of German yields caused me to be somewhat apprehensive and, therefore, full allocations were never established. At the Euro's inception, Professor Milton Friedman was highly dubious of its structure and thought it would fall apart at the first external shock. I came to a similar view, as I reflected on its formation and structure, realizing that it represented only a monetary union rather than a fiscal one, thus, it had a weak foundation.

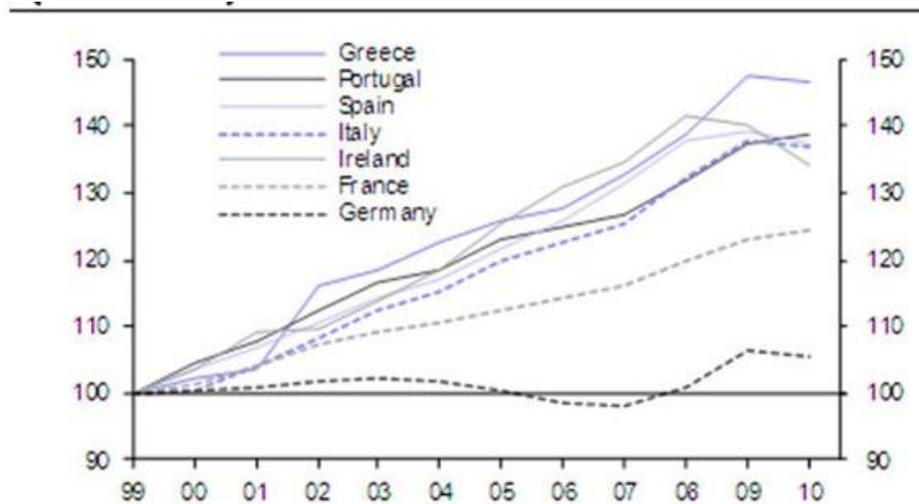
Establishing a fiscal union is enormously difficult, especially among divergent cultural groups. Had it been easy, it would have been accomplished at the Euro's inception. The last two years have laid bare this fundamental issue despite band-aid "solutions" concocted at numerous summits. After the critical summit on December 9, a "fiscal compact" was proclaimed. I still don't know or understand what this means other than they will work toward some form of fiscal integration while implementing "new" controls and punishments. Pardon me for being skeptical but haven't we been down this road before

with the EU's 1998 Fiscal Stability and Growth Pact? First Germany and then France violated these regulations followed by nearly all the other member countries. In my opinion, it is hard to put this genie back in the bottle.

While the perception of sovereign equivalence was strong, Euro members should have worked to narrow their cost competitive differentials. Exhibit 4 below shows how German unit labor costs were

EXHIBIT 4

Whole Economy Unit Labor Costs (1999=100)



Source: OECD and Roger Bootle, Managing Director – Capital Economics

well controlled while other member countries, particularly the PIIGS and also France, were not. Without a convergence in competitiveness, it is difficult, if nearly impossible, to maintain a single currency. Devaluation of the Euro was not an option among these inefficient countries so, to maintain peace on the home front, government debt, entitlements and other social benefits were allowed to grow rapidly. Germany, in order to build and protect its exports markets, made a Devil's bargain by aligning with several of these countries so as to eliminate the risk of competitive currency devaluation.

Analyzing the twists and turns of the European debt crisis has been a roller coaster ride, particularly with the banks. A faulty risk weighting methodology, under the Basel Accords, for determining bank capital requirements, contributed to the 2007 to 2009 credit crisis and this euro-zone mess. It's amazing to me that this methodology continued since governments and banks were likely to become even more conjoined, leading to potential conflicts of interest. The July 2011 bank stress test exercise is an example of this apparent conflict, when only eight banks were deemed to have a capital shortfall of €2.5 billion, and this was with most sovereign debt included at a zero risk weighting while the Greek crisis was worsening. By December, the shortfalls had increased to €115 billion for 31 banks, while some believe the real number may now be greater than €200 billion. Who knows what the actual number is

but the capital markets seem to finally have had enough of these games and, accordingly, European bank funding all but stopped, except for their borrowing from the European Central Bank (ECB).

Now that Greece and Italy are pressing the limits of the euro-zone structure, the jig is up and politicians are looking to the ECB to bail them out. The ECB's independence is being questioned since it purchased €217 billion of sovereign debt, mostly Italy, Spain and Greece, while rapidly expanding its balance sheet through the use of non-standard monetary measures. Jens Weidmann, the new president of Germany's Bundesbank, is strongly opposed to making the ECB the lender of last resort in efforts to support the Euro.⁸ With over 2 trillion of Euro debt maturing this year, sovereign debt refinancing has now become prohibitively expensive for many countries while this window is closed for European banks. Despite a new European Stability Mechanism of €500 billion that replaces the European Financial Stability Fund this July, €150 billion Euro area government bilateral loans to be funneled through the International Monetary Fund, and the ECB's remaining balance under its sterilized bond buying program, the nearly €1 trillion in support mechanisms appeared inadequate to me to stop the Euro crisis.

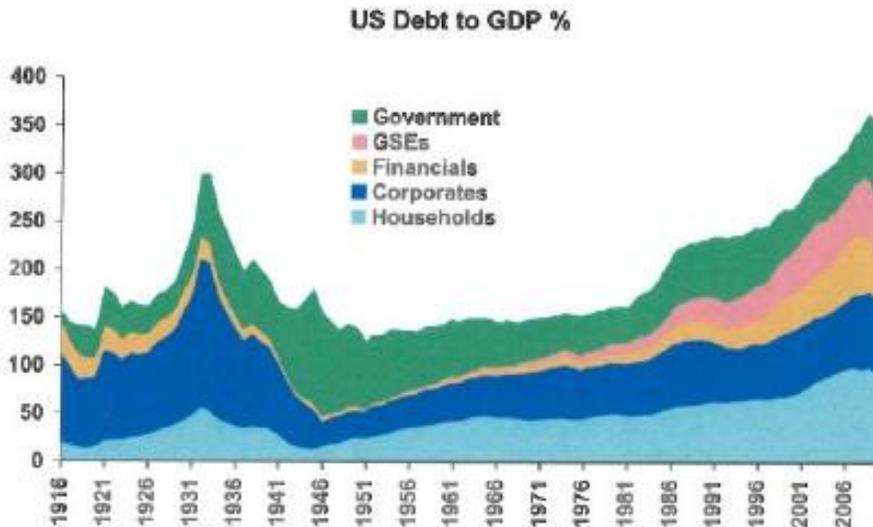
On December 21, the ECB established its new Long-Term Repo Operation (LTRO) that provided €489 billion of three-year 1% loans to 523 banks. At almost twice the expected demand, it demonstrated the seriousness of the banking crisis. A second LTRO takes place on February 29. Shorter-term borrowing costs have declined but longer term sovereign debt yields for Italy, Spain and France, remain elevated indicating that serious reservations persist about the program's potential long-term success. "Banks represent about 80 percent of the lending to the euro area," according to ECB President Mario Dragi.⁹ The linkage between banks and their sovereign governments will likely increase since many expect these loans to be recycled into additional sovereign debt, hopefully into more periphery debt. Additionally, the ECB relaxed its lending standards so that, in some cases, single-A asset-backed securities may now be pledged as collateral. These initiatives are nothing more than rescues or backdoor bailouts that further reward unsound fiscal and financial behavior.

Will this ploy resolve the euro-zone crisis? I believe for only a short period, unless a fundamental restructuring of the EU occurs. Italian Prime Minister Mario Monti's December budget plan introduced rules that allow banks to issue bonds, guaranteed by Italy, as collateral for loans from the ECB. Playing this game of recycling money to the banks, so they can buy sovereign debt, allowing sovereign countries to go on their merry way, resembles a shell game. It's **DELUSIONAL!** I am skeptical there is the will or the ability to reform the EU because it will require ceding fiscal sovereignty to another. The combination of fiscal austerity and rising interest rates means Europe is either near, or already in, recession. The Euro's structure will face additional tests until at least one or more members exit. Should the weaker countries exit, a stronger Euro is likely. If there are no exits, it means transfers of wealth from the northern to the southern euro-zone countries, which would result in a weaker Euro and a more unstable EU. On January 13, Standard & Poor's downgraded France, Italy and seven other European countries while assigning France and 13 other euro-zone nations a negative outlook. Without any exits, the next round of downgrades will likely encompass Germany's AAA status. EU structural uncertainty and high system-wide leverage should make for a difficult European investment environment.

Japan is next up on my list with a total debt to GDP of 471%; the government portion is equal to about 200%. Because nearly 95% of government borrowing is sourced from internal sources, its cost to borrow ten-year money has averaged less than 1 1/2 % since 1998, allowing Japan to escape a European-style debt crisis thus far. Many speculators have been burned attempting to short Japan's non-sustainable debt trend. This decade may prove to be different because of demographics. Its population peaked in 2004 and 2011 marked the fifth straight year of population decline while being the largest since 1947.¹⁰ The pool of bond buyers may be cresting since the primary demographic pool of demand, ages 55-75, peaked in 2010 and is expected to fall by 170,000 per year this coming decade.¹¹ Additionally, Japan's Government Pension and Investment Fund, the world's largest pension fund, with approximately 68% of its assets deployed in domestic debt, recently began selling some of these bonds to pay pension benefits. The country's generation of savers is now retiring and the household savings rate is likely to turn negative in the coming decade.¹² Also worrisome is the new April 2012 budget which anticipates being funded by debt issuance to the unprecedented level of 49%; the fourth consecutive year that new bond issuance has exceeded tax revenue receipts. A primary budget balance, before bond sales and interest payments, is not anticipated until 2020.¹³ It is hard to imagine how Japan's bond or equity markets will perform well under such negative headwinds.

The final member of this trio of fiscal misfits is our own United States. Exhibit 5 below shows that U.S. total debt to GDP is nearly 350%, and this is before taking into account off balance sheet entitlement liabilities and guarantees that would bring it to more than 500%. Deleveraging by the corporate (dark blue) and household (light blue) sectors is being partially offset by rapid growth in government debt.

EXHIBIT 5



Source: Federal Reserve, BEA, Haver, Historical Statistics of the U.S., Morgan Stanley Research

I have been highly critical of our nation's fiscal policies and budgetary trends for years. Both political parties disgust me because of their incredible fiscal ineptitude and unwillingness to be truthful with the

American people. A chaotic future will be the result if our representatives continue to fail at their fiscal restructuring responsibilities. It is easy for me to speak of Europe and Japan in cold clinical terms, but not the U.S.; this is home and our nation's fiscal mess is like a life threatening cancer that is not being treated.

Fiscal reform is an immensely challenging task and it will be made more difficult by substandard economic growth. In my May 2009 Morningstar conference speech, "Reflections and Outrage," I estimated it would take approximately ten years to rebuild household net worth back to its 2007 pre-crisis level. Negative economic structural shifts, particularly in manufacturing, housing and housing related industries, would likely result in an elevated level of long-term unemployment and reduced living standards. Deleveraging would become a new goal. A higher savings rate would be necessary to help rebuild net worth lost due to the real estate and stock market collapses. Therefore, for the foreseeable future, a substandard real economic growth rate of a little over 2% would likely unfold. Since the Great Recession's trough in 2009, economic growth forecasts by the Congressional Budget Office, President and Federal Reserve have been consistently overly optimistic, unlike mine. I anticipated a caterpillar-like recovery, with temporary growth spurts driven by short-term fiscal and monetary stimulus programs while a slowing would ensue as these were withdrawn. A traditional recovery growth rate would not be achieved. I believe that the repeated attempts at fiscal and monetary stimulus since then confirm my original conclusions.

Has my consumer financial outlook improved since my 2009 forecast? Not much. The consumer's balance sheet has recovered somewhat but total household net worth is still down by more than \$9 trillion from its April 2007 peak of \$66.8 trillion. Total household debt is down by nearly \$700 billion from its April 2008 peak; however, between 2000 and 2007, it grew by \$6.6 trillion dollars (101%) to \$13.1 trillion. Annual debt servicing cost has declined by about \$200 billion but a large portion of this contraction is a function of mortgage foreclosure and the ceasing of debt repayments.¹⁴ The ratio of debt to personal income has improved by declining to 114% from 130% at its 2007 peak: however, it remains far above the more typical 90% level of the late 1990s that preceded the consumer debt bubble. According to BCA Research, assuming household incomes grow at an average annual rate of 4.5%, questionable, while debt increases at 2%, this ratio will not return to its 2000 average until 2020.¹⁵ The Fed's zero interest rate policy (ZIRP), which I consider to be so egregious and deleterious to savers in this country, has retarded a recovery in gross personal income by an estimated \$400 to \$600 billion annually. I believe it to be a dangerous policy and it will result in serious negative unintended consequences as financial institutions, in an attempt to maintain profitability, increase balance sheet risk. This is a silent growing threat.

I viewed the consumption enhancing stimulus programs of both Presidents Bush and Obama as being ineffective and wasteful, with little bang for the buck, while consumers were in a deleveraging process. Arguments for and against these initiatives have been heated, but this is not the first time that such debates have occurred. Back in 1932, similar disputes unfolded between what would become known as the Austrian and Keynesian schools of economic thought. They focused on the efficacy of stimulating consumption as opposed to "real investment" and the ineffectiveness of "...imprudent borrowing and spending on the part of public authorities."¹⁶ As a side note, Neville Chamberlain, Chancellor of the

Exchequer, initiated a policy of “quantitative easing” in May 1932, as a means of creating “cheap money.”¹⁷ The more things change, the more they remain the same. Unsound fiscal policies waste time and treasure and, thus, prolong long-term structural unemployment while delaying economic recovery.

Both major parties are guilty of irresponsible budgetary management; it doesn't matter which is in power, as the federal debt spirals continuously upward. President Bush and the Republican dominated congress kick started this fiscal mismanagement process by initiating wars, enacting two major tax cuts and establishing a new entitlement program, the 2003 Medicare prescription drug act that created a present value liability larger than the comparative \$7.1 trillion national debt. Not to be outdone, President Obama and the congress shifted into high gear. While Treasury debt grew by 61% over eight years under President Bush, it surged by nearly 66% under President Obama, in just under four years. To put this insanity in better perspective, during the past 62 years, a budget surplus has occurred only nine times for an accumulated total of \$576 billion. In each of the last three years, budget deficits have been more than twice this amount. And it will occur again this year. This is **OUTRAGEOUS!**

Last year's budgetary soap operas were truly discouraging. The two debt limit increase agreements were a farce! The “cuts” to be realized are questionable since most of them are deferred into the distant future, or are simply illusory. The August debt limit agreement typifies these deficit “cutting” shenanigans. Only \$22 billion out of the \$917 billion ten-year total estimated cuts are scheduled to begin this year, while approximately two-thirds do not start until after 2016. By the way, this year's cuts have already been wiped out by a factor of five-fold as a result of the 2011 Social Security payroll tax reduction. If it is extended for 2012 without offsets, another \$120 billion will have to be borrowed this year. Again, we see more short-term attempts at stimulating consumption which will have no positive lasting effect and, in reality, simply puts us further in the hole.

Throughout this deficit cutting dance, Chairman Bernanke has argued that no material expenditure cuts should be made in the initial years for fear of harming the nascent economic recovery. His view provides cover for politicians who favor postponing any substantial early cost cutting. **I VEHEMENTLY DISAGREE** since his record of accurate forecasting is questionable.

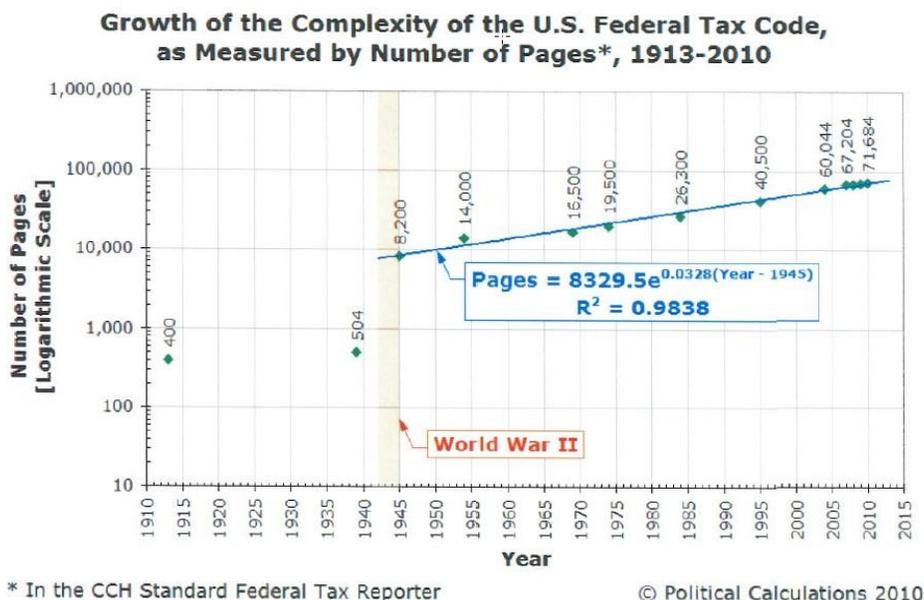
So what does this mean?

The November election and the Supreme Court's ruling on the new health care law will be of critical importance. The American people have to help guide the nation's leaders in prioritizing the fiscal agenda. Until then, I expect nothing will be accomplished. The Super Committee's abject failure underscores the inability, incompetence and dysfunction that reside in Washington. A mere \$1.5 trillion reduction in anticipated spending, out of \$44 trillion, over ten-years couldn't be achieved. Sequestration of \$1.2 trillion begins 2013 but I highly doubt that it will occur as it is presently designed. “Indeed, political disunity is often a key driver of sovereign defaults and financial crises,” according to Reinhart and Rogoff.¹⁸

I believe 2013 is the most crucial year, of the past 80 years, for fiscal budgetary reform and the potential of new health entitlements makes a grand bargain more difficult to attain. Success or failure in this process will determine this nation's economic stability in the next decade. I agree with the view of Dave

Walker, former Comptroller General of the U.S. and founder and CEO of the Comeback America Initiative, to which I am an advisor. He states that, “If we expect to avoid a debt crisis in the U.S., it is critically important that steps be taken to facilitate achievement of a grand fiscal bargain in 2013.” If any of you would like to help, contact Dave at dwalker@tcaii.org. Unless there is restructuring of the nation’s entitlement programs, congressional budgetary reform and a simplifying and balancing of the U.S. tax system, this nation will travel down the unfortunate paths of Europe and Japan. For starters, entitlement reform should include benefit cuts, an increasing of the age for qualifying, and means-testing. Congressional budgetary reform must include statutory controls that prevent a future congress from overturning expenditure cuts enacted now but are to be implemented later. Finally, tax reform is desperately needed. The following exhibit demonstrates, in a quantitative fashion, how the U.S. tax code has grown and become totally bizarre at nearly 72,000 pages and has nearly tripled since 1984. Fiscal reform must be clear, credible and show a timely implementation.

EXHIBIT 6



If congressional failure continues, Dave Walker and I discussed what may be the only other option available and that is attempting to amend the Constitution via the Madison process. This has never been undertaken before. It requires that two-thirds of the state legislatures support an identical amendment calling for a constitutional convention to vote on enumerated issues centered on fiscal reform. Examples might be: a debt/GDP limit with statutory controls; a balanced budget amendment; and a presidential line item veto. Ratification requires three-fourths of the states legislatures or state ratifying conventions approving it—an extremely difficult challenge.

If credible and material fiscal reforms are not implemented by the end of 2013, I fear that, between 2014 and 2016, this nation will confront a crisis similar to that of Europe. Time is running out because, starting in 2018 and continuing through 2024, various entitlement trust funds will be either depleted or beginning the process of liquidation. Budgetary financial pressures will explode. Treasury debt

outstanding could easily rise to between \$22 and \$25 trillion by 2022. With just a 200 basis point rise in the average funding rate, debt interest cost could rise to at least \$1.2 trillion, thereby wiping out most of the savings from sequestration. Every additional year wasted beyond 2013 will increase the size and scope of the necessary fiscal response; furthermore, negative capital market reactions are more likely. Congress and the president should not become complacent, given today's low Treasury yields. Without reform, this is only a temporary calm before a much larger storm.

Are these risks discounted in either the U.S. stock or fixed income markets?

Exhibit 7 shows that the S&P 500's P/E ratio, the yellow line, has declined over the past 12 years to a level not seen since the mid-1950s and is the longest sustained decline in a half century. Many consider the stock market reasonably or cheaply valued, when compared to history, so, its current valuation discounts numerous risks. The corporate earnings recovery surprised many, including me, particularly

EXHIBIT 7



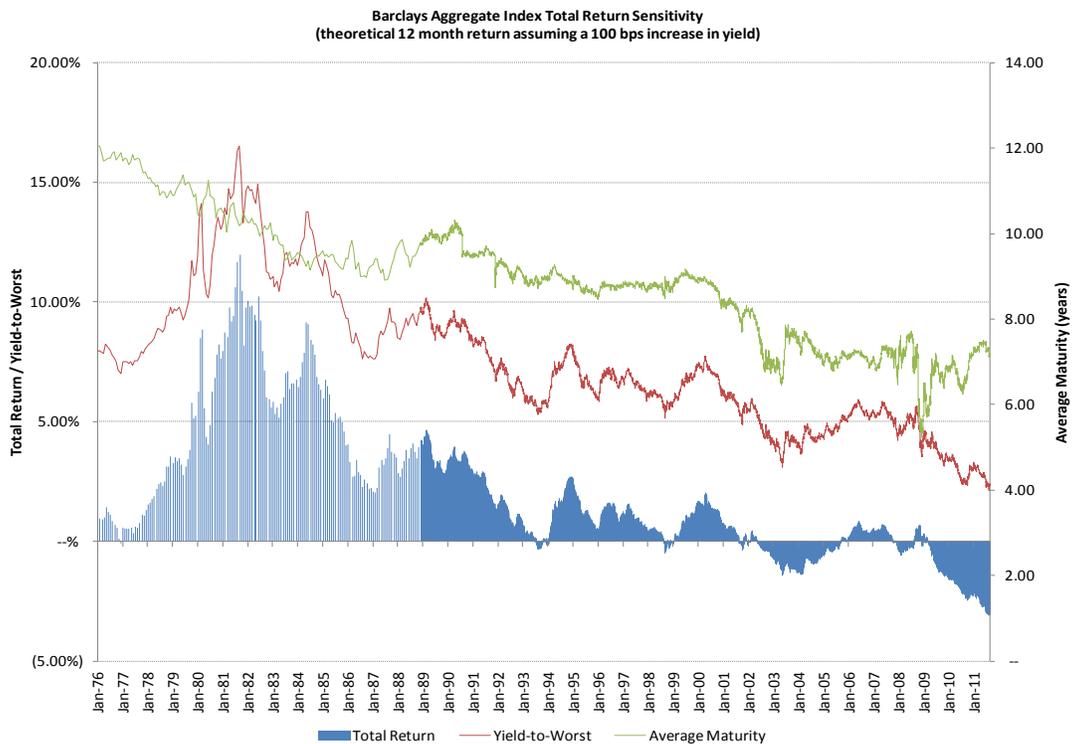
Source: Bloomberg

with near record pre-tax profit margins, despite substandard economic growth; therefore, case closed-- but not so fast. Upon closer examination, 73% of the non-financial corporate pre-tax profit margin expansion resulted from lower interest (38%) and labor (35%) costs.¹⁹ Furthermore, approximately 45% of the S&P's revenues are internationally sourced, so European and Japanese recessions pose additional risks. Contagion from Europe should not be underestimated since European banks dominate emerging market lending. I believe the market's P/E decline reflects the growing risk of profit margin contraction, a sluggish economic growth outlook, fiscal policy mismanagement and international economic uncertainty. Increased market volatility adds to this list, as portfolio managers digest and react to news almost instantaneously. When a company's operations are viewed as having low growth expectations, combined with peak margins and high volatility, investors typically ascribe a lower P/E valuation to the

company's stock. This portrayal describes the market and, therefore, a higher margin of safety, through a lower P/E, should be required for an aggressive equity allocation. In my opinion, low to mid single-digit returns will be the norm for the next decade and this may prove to be optimistic.

My bond market view is worse. Exhibit 8 on the next page demonstrates how much risk, and little return, there is if interest rates rise by 100 basis points in one year for the Barclays Aggregate Index. The possibility of capital loss, denoted by the negative blue bars, has been increasing and is now at a

EXHIBIT 8



Source: Barclays Capital

record level. Though longer-term Treasury bonds were among the best performing asset categories last year, consider the risk taken. Who would be willing to buy them, at these absurdly low yields, unless they were able to sell quickly? I believe no one. It's speculation since there is little, if any, underlying real value. Protect your capital and stay within a three-year maturity. Without a material improvement in the fiscal outlook, these low rates should prove to be unsustainable. Remember the suddenness and magnitude of the interest rate rise for Italian and Spanish ten-year sovereign bond yields this past year. Over the next decade, I expect low single-digit to negative total returns for intermediate and long-term bonds.

So how are we positioned, given this negative outlook?

In stocks, we are cautious -- defensive but opportunistic. Dennis Bryan and Rikard Ekstrand have been my trusted associates for many years. In 2010, they succeeded me as leaders of our Small/Mid-Cap Absolute Value Strategy (SMAV) and have continued the strategy of high cash and concentrated investments initiated in 1998. Flexibility, patience and discipline remain key elements in the product's capital deployment approach. They view the small/mid-cap sector as being relatively expensive with P/E ratios above 20x. Since the beginning of the year, they have sold three-times more than what they have purchased by reducing two technology holdings, one retailer and an energy company. Though they have added seven holdings in the past 18 months, none are full positions. As an example, AMERIGROUP Corporation is the largest pure play Medicaid insurance company with \$6 billion in revenues. Its products generally provide cost savings to states of up to 20%, thus, they are benefiting from increased outsourcing. It has consistently generated cash flow greater than net income though interest income from its large cash holdings is being hurt by low short-term investment yields. At 12x earnings, 1 1/2x book value, a mid-teens ROE and effectively no net-debt, the team believed its share price discounted several negatives at \$40. Another is Oshkosh Corporation, a leading specialty vehicle manufacture in the military, aerial work platforms and the safety equipment fields. They estimate a sum-of-the parts value of about \$50-60 and this assumes depressed operating conditions in the military segment at just a maintenance level with some business recoveries in the other operations. With a strong balance sheet, generating free-cash flow and selling at 1 1/2x book value, they view it as a value at \$25. Liquidity levels remain high, at about 30%. Their value screens do not display an abundance of qualifying names, given that recently, only 101 passed. Typically, about 200 qualify, while a record low of 40 was set in June 2007 versus the high of 450 in March 2009. Security selections tend to be one-offs and no industry stands out which is unusual. In a word, it's frustrating.

Our Absolute Fixed Income Strategy product currently pursues a capital preservation strategy by being highly defensive. Tom Atteberry succeeded me in 2010, after being my assistant and co-manager for several years. He and I have been unwilling to extend portfolio duration in a world of monetary excess and fiscal policy abuse, as reflected by a near record-low portfolio duration of 0.8 years. During the height of the credit crisis in 2008 and 2009, when there was little trust and high fear, we were gratified to see record inflows into our bond fund because of our known high credit quality standards. Tom and his team continue to scour the high quality bond universe for shorter-term investments. The 10-year agency mortgage sector, issued after 2009 with underlying mortgage rates of 3% to 3 1/2%, is attractive to us. They provide yields in the 1 1/2% to 2 1/2% range and have average lives between 2.5 and 4 years. These borrowers are of high-quality and have a goal of owning their home so refinancing tends to be of a lower priority. Nearly \$500 million out of \$1 billion has been deployed in this area since September. Additionally, GNMA project loan securitizations were purchased with yields between 1 1/2% and 2 1/2% with average lives of 2 to 3 years. These are government assisted living and retirement home developments. The interest only portion of the securitization provides a return of about 6%, with an average life of five years, but has a higher risk that is a function of default rates. These are base hits and nothing more. Everything that is being purchased is with a 5-year or less maturity/average life. We view the high-yield market as unattractive because of its low absolute yield. Because of our capital preservation focus, typical intermediate term performance benchmark comparisons are of little interest

to us. We emphasize the concept of **ROC Squared**—Return on Capital and Return of Capital; it is the second element that receives top priority in our thinking.

I know many of you would like more actionable ideas but principal protection is uppermost in my mind. Patience is required now. I believe many investors underestimate the potential risk and disruptiveness from high global financial leverage. We are in Phase 2 of continuing and expanding economic and financial market instability. Flexibility, high liquidity and concentrated asset deployment, when appropriate, will be key elements in attaining superior investment performance. The era of being fully invested and adjusting portfolio weights relative to an index has been over for more than a decade.

In closing, during my long career, I have made many mistakes. These mistakes, and my pursuit of understanding why they occurred, have been instrumental in helping me to anticipate consequences. As Norman Cousins said, “Wisdom consists of the anticipation of consequences.” When you make a mistake, embrace it as a learning experience, analyze why it occurred, and increase your financial wisdom. I wish you all good hunting and safe journey through these turbulent times.

Remember, **CAUTION: DANGER AHEAD.**

Thank you.

¹ FPA Capital Fund, Inc., Annual Report, March 31, 1998, p.3.

² Dr. Richebacher’s retirement party from Dresdner Bank in 1982.

³ “Crossing the Rubicon,” Robert Rodriguez, March 30, 2008

⁴ “A Historical Public Debt Database,” IMF Working Paper November 2010, S. Ali Abbas, Nazim Belhocine, Asmaa ElGanainy, and Mark Horton, p 11.

⁵ “This Time Is Different: Eight Centuries of Financial Folly,” Carmen M. Reinhart & Kenneth S Rogoff, p. xxxiii.

⁶ *Ibid.* 4, p. 10.

⁷ *Ibid.* 5, p. xxx.

⁸ “Germany’s Central Bank against the World,” Spiegel Online, November 15, 2011.

⁹ “European Banks Devour ECB Emergency Funds Amid Frozen Markets,” Bloomberg, Gavin Finch and Liam Vaughan, December 21, 2011.

¹⁰ “Japan Population Drops Most Since World War 11,” Aya Takada, Bloomberg, January 1, 2012.

¹¹ “Japanese Government Bond Demand to Turn a Corner,” David Munro, OANDA Corporation, July 28, 2011.

¹² “Symposium on Asian Banking and Finance,” Masao Hasegawa, Mitsubishi UFJ Financial Group, September 9, 2011.

¹³ “Japan Budget’s Dependence on Bonds to Rise to Record Next Year,” Toru Fujioka, Bloomberg, December 25, 2011.

¹⁴ “The Dark Side of ZIRP,” Neal Soss, Credit Suisse, US Economics Digest, November 21, 2011, p. 4.

¹⁵ “Outlook 2012,” The Bank Credit Analyst, January 2012, p. 12.

¹⁶ “From the Great Depression to the Great Recession: The 1932 Hayek-Keynes Debate: A Study in Economic Uncertainty, Contingency, and Criticism,” David Hingstman and G. Thomas Goodnight, *Poroi*, Volume 7, Issue 1, Article 5, 2011, p. 10.

¹⁷ *Ibid.* p. 5.

¹⁸ *Ibid.* 5, p. 53.

¹⁹ *Ibid.* 14, p. 12.