

LUMBAR D
INVESTMENT
COUNSELING

INSIGHT

Nasdaq Composite 2,611* Dow Jones Industrials 13,595 * 30 year U.S. Treasury Bond 5.07%

RISKY BUSINESS

There is plenty of money around. Three years after the Fed started raising interest rates—and almost a year after they stopped—cash still runs in rivers through the canyons of Wall Street. It's a frothing, foaming torrent, topped with glistening bubbles in commodities and foreign junk bonds. And foreign junk stocks! Micro-cap companies founded by former members of the Chinese Communist Party! If it's risky (*the toxic waste from mortgage pools!*) investors are willing to pay a premium price. This is, after the all, the Year of the Pig.

Obviously, this is all going to come to a bad end. This is a bubble, driven by the notion that risky investments always produce the highest returns. Take out the word "always" and you have a true statement that has been inflated beyond reason. That's always the way it is with bubbles, and when you look back on the tech-stock, real estate, and dollar bubbles you see that they were built on humble truths that were then inflated to grotesque proportions.

The Fed might be guilty of printing too much money in recent years,

but right now it's the frenzied actions of investors and financiers that are pumping up economic activity. In an odd reversal it's the markets that are driving the economy, even as the banks turn the monetary screws tighter by refusing to give no-money-down mortgages to bankrupt illegal aliens.

The party will continue as long as investors are willing to lend to anybody who asks for money, and drive up the prices of IPOs and private-equity buyouts. In this era of euphoria everybody feels richer, and ever-more-daring. Suckers are pushing their way to the front of the line, clamoring for a piece of the action.

Yet some day the tide will go out. Confidence will evaporate, and that will be the end of that. The most likely cause would be the economy, which is now in a condition that's best described as stagflation. The ethanol mania is pushing up the price of food even as Wall Street traders bid up the price of gasoline—along with crude oil, gold, copper, and every other commodity—while the economy sputters along in fits and starts.

Don't look for the Federal Reserve to fight that inflation as long as the economy continues to stagger under the weight of rising mortgage defaults and falling real-estate prices. And don't expect them to boost the economy with lower rates as long as Wall Street continues to drive inflation in the commodity markets. We're stuck right here, but there's an overly-plump chicken in every pot and three oversized cars in every garage. The tide is high, the sun is shining, and the herd is still running shoulder to shoulder.

"CBO [the Congressional Budget Office] and Congress's Joint Tax Committee originally estimated that reducing the capital gains rate to 15% from 20% would cost the Treasury \$5.4 billion from 2003 – 2006.

Whoops. Actual revenues exceeded expectations by 68%, creating a \$133 billion revenue bonanza for the feds."

-- The Wall Street Journal

HOUSE POOR

“For the grasshoppers, there’s nothing quite as stupid as paying off your 2002 trip to Orlando in 2032, when you finally settle up your refinanced “cash out” 30-year mortgage. And for the ants, economic studies have demonstrated over and over that houses (1) cost more than most people make when they sell and (2) rarely match the long-term returns of stocks or other investments.”

-- David Crook,
The Wall Street Journal

A GLUT OF McMANSIONS

“A recent study by Spectrem Group, a consulting firm in Chicago, found that almost two-thirds of affluent baby boomers intend to finance their retirement by selling their homes.”

The Wall Street Journal

“... the real problem in this story is the fact that the Federal Reserve allowed the housing bubble to inflate to ridiculous levels in the first place. There is no pretty way to deflate an asset bubble, as should have been apparent from the collapse of the stock bubble between 2000 and 2002.”

-- Dean Baker, Co-Director,
Center for Economic and Policy
Research

LIPSTICK ON THE PIG



Private Equity. It sounds exclusive, yet equitable. Elitist, but sensible. It’s the latest Baby-Boomer-Bubble fad, and it has all the appeal of a get-rich-quick scheme.

Many of these funds are buying public companies, hopefully with the collusion of their CEOs (who are in a position to depress their share prices by making negative comments). The newly-private companies are now free of all the reporting requirements that now burden public companies, allowing some cost savings as well as the blessed cover of darkness. Far

from the prying eyes of the media, the new owners start cutting costs—fat, muscle, and bone—and otherwise buffing up the company for future sale. Putting lipstick on the pig.

The end game is to go right back to Wall Street, as soon as possible, and sell the company to a new set of investors at a higher price. If, that is, they can find enough investors to buy all the shares of all the companies that the private-equity firms plan to flip. “Can I put you down for 1,000 shares of Chrysler?”

ANOTHER BUBBLE DEFLATES

The real estate and mortgage markets are looking every bit as troubled as we expected, but the economy is still growing, slowly. And employment is still growing. In fact, the Labor Department claims that employment is still strong in the construction trades. During the last year residential construction has declined 33%, yet the number of residential-construction jobs has declined by just 3%.

Economists have been scratching their heads over the disparity, but the answer surely relates to the large number of illegal immigrants employed by home builders. Many of these workers never appeared in any

statistic, because they lived off the books in a cash economy that knows no FICA or unemployment insurance. It’s likely that the huge employment gains of the last 4 years were even larger than the 6.5 million new jobs reported by the Bureau of Labor Statistics. Probably millions larger, given the huge size of the illegal immigrant population. Journalists called it “the jobless recovery” . . .

Now, under pressure from declining housing starts and increased scrutiny from immigration officers, many of these undocumented workers have been laid off. Without a trace. The official unemployment rate is still 4.5%.

A SURE-THING, 100 TO 1 SHOT

If an 18 year old student puts \$100 into an IRA this summer—and the money grows at an 8.9 % rate until the age of 72—she'll have **\$10,000** to spend in retirement. Yes, it's hard to get a good return on a tiny account; and it should also be said that the number of larger investors who achieve an 8.9% return is dispiritingly low (because so many have a practice of jumping from one hot mutual fund to another). But this is a clearly-achievable goal, and it offers a simple and powerful incentive for savings.

The power of compounding looks a lot less impressive if you start later in life. It's important to get a good return, but TIME is the real key to getting rich. With proper investment any pool of savings will double every few years; at a low rate of interest it will take longer to double, but it will still double and double again. The key point we'd like to make is that the first couple of doublings are barely worthy of mention, but that the fourth doubling is always an eye opener.

This concept is hugely relevant to a student choosing between, say, a prestigious and well-endowed college that charges \$48,000 a year, and a good university which offers a scholarship or in-state tuition for \$23,000 a year. Over four years the difference is a vast and meaningful \$100,000, with decades of growth ahead.

Yes, most families choosing the prestigious school would borrow that \$100,000 difference, but that doesn't make the lifetime financial impact any smaller. Compound that sum over the

course of 50 years, devilishly assuming a 10% rate of growth, and it will double 7 times. The first doubling gets you to \$200,000, the second to \$400,000, and the third to \$800,000. As promised it's the fourth doubling, to \$1,600,000, that gets your attention---and in our example the investor is not even 50 years old.

After 50 years and seven doublings, the account holds **\$12,800,000**. Next time you have the urge to contribute to higher education, you might want to send the check to a school that's holding the line on tuition increases.

Another strategy is to write that check to a medical school. In the last 25 years the number of new medical students (per 100,000 U.S. citizens) has dropped more than 25%. We're going to suffer a severe shortage of doctors in a few years, and one reason is that universities lose money on their medical schools while they make money on their law schools. Law schools continue to expand

“Our investment process starts and ends with our Dynamic, Proprietary, Global, Continuously-monitored, Real time, Momentum-driven Asset Allocation Model.”

“In a nut shell, we patiently hold cash until we're sure that we see a mania. Then we buy. Fearlessly.”

“At age 10, American students take an international test and score well above the international average. But by age 15, when students from 40 countries are tested, the Americans place 25th.

American schools don't teach as well as schools in other countries because they are government monopolies, and monopolies don't have much incentive to compete. In Belgium, by contrast, the money is attached to the kids — it's a kind of voucher system. Government funds education — at many different kinds of schools — but if a school can't attract students, it goes out of business.”

-- John Stossel of ABC News, author of “Stupid in America”



HEDGE FUNDS



Drew D. Kellner

In recent years hedge funds have been viewed as low risk, high return investments that regularly outperform the market. The truth, according to a study by Dimensional Fund Advisors, is that hedge funds underperformed the S&P 500 from 1994-2004 by an average of 2.5% per year. The risks are also substantial, because these

firms disclose little information to their investors and borrow huge sums to magnify the impact of every trade.

The most dramatic failures were those of Long Term Capital Management (1998) and more recently Amaranth Advisors (2006); they lost billions of dollars over the course of weeks and months until they finally collapsed. Today John Henry, the owner of the beloved Boston Red Sox, runs a hedge fund that has seen its assets under management drop from \$2.5 billion last year to just \$500 million this year because of poor performance (down 24% in the past year) and investor withdrawals.

So what does one have to pay for high risk and often-poor performance? The typical hedge fund takes 20% of all your profits, and also charges an annual 2% fee in good years and bad. They call it "Two and Twenty". Thanks, but No Thanks.

JUMPING FROM ONE HOT MUTUAL FUND TO THE NEXT

"Over the last 20 years, the stock market has averaged a 12 percent annual return. But according to a study by Dalbar Financial, individual mutual fund investors earned only about 4 percent. A survey by Vanguard finds that participants in its 401(k) plans earn only about 6 percent a year."

-- Neil George
Editor of Personal Finance

According to Morningstar, Inc, the tenure of the average mutual fund manager has dropped to 4.5 years. Manager turnover is usually accompanied by portfolio turnover, and that means higher brokerage costs and trading costs---as well as realized short-term capital gains.

There's no point in spending a lot of time choosing a mutual fund manager or a trust investment officer if he's only going to be around for a year or two. We're here for the long haul.

KOREA ELECTRIC POWER

Our clients have held Korea Electric Power (KEP - \$22) since the shares sold for \$8 each. In recent years the stock's ascent has slowed, as the company struggled with the cost of imported fuel. Those price increases have not been passed through to customers, and profit margins have steadily contracted.

Revenues have grown rapidly with the growth of the South Korean economy. Eventually the shares will begin to catch up with the growth of revenues, either because the government allows higher rates or because the cost of fuel declines. We think that the latter is more likely, and we like the diversification that KEP brings to a portfolio. If the world economy weakens, the price of oil and coal will decline, and the shares of Korea Electric Power will rise.

The "chief operating officer of global markets" at Enron has launched a hedge fund. If you'd like to sign up you can reach Trident Asset Management, LP, in Houston

"Economists are backing away from predicting a recession anytime soon; 62% of those on a National Association of Business Economists panel don't expect a recession within the next three years."

-- The front page of The Wall Street Journal, December 11, 1989. A recession started seven months later.

QUADRUPLED !

When a friend saw that our real-world, cash-bonds-and-stock benchmark account had quadrupled, he said that it wasn't a fair representation because the last decade included the tech stock bubble. Thus, it was easy money.

Well Hello Scott!! Those years also included the *bursting* of the tech stock bubble. The big tech stocks dropped 80% between 2000 and 2002, and even today they're at just 40% of their peak value.

Meanwhile our benchmark account—a real account that one of our wonderful clients established in 1990—has continued to grow. The portfolio has always been invested just like our other “balanced” accounts, and

our client has kept it segregated and untouched just so that we'd be able to track it. We don't show it any favoritism in trading, and it performs no better than its peers. It pays fees at a 1% rate, and it has always been invested in a conservative-yet-global mix of bonds, cash, and stocks. The account now stands at **\$451,243**, up from \$100,000 in October of 1990.

That excellent performance is matched by terrific service. Our full attention is directed to the needs of just 46 terrific clients who have given us the responsibility for managing more than \$57 million. Further information regarding performance, fees, and our account minimum can be found at www.lumbard.com.

Photo by Rick Balboni



John Lumbard, CFA

SHAW GROUP

Shaw Group (SGR - \$40), parent of highly-regarded Stone & Webster, is an engineering firm with a huge backlog of coal and nuclear-power-plant contracts. The company just bought 20% of Westinghouse, one of the world's few nuclear-reactor companies, and it also has a big business supplying custom-formed pipes used in power plants and other high-stress applications. Shaw's profit margins have been very small, but the revenues are large and growing---and relatively invulnerable to economic weakness.

We bought the shares, mostly in the low to mid 30s, because we believe that the enormous demand for power-plant engineering services will cause profit margins to improve. Even at \$40 the company's shares sell for a fraction of its annual revenues, so a modest improvement in profit margins will bring big benefits to the bottom line.

A SILENT MAJORITY

Despite all you've heard from Mahmoud Ahmadinejad, the Iranian people do not hate us. Relations between Iran and the United States are about to thaw, and the biggest beneficiaries will be Iran's Shiite brethren in Iraq. The American press has somehow failed to recognize that Iraq's Shiites represent 65% of that nation's population, and that they have been responsible for only 15% of the violence. Even then it should be noted that (Sunni) al Qaeda mercilessly and purposefully goaded Iraq's Shiites to launch reprisals, in an effort to create a civil war.

CORN OIL

Ethanol is just another subsidy for Big Agriculture. By waiving the federal tax on ethanol we've slashed revenues for the federal government—and made it inevitable that we'll have to raise taxes somewhere else. It's not hard to guess that the eventual result will be an increase in the income tax.

We should be *raising* gas taxes and *cutting* income taxes, but instead we're doing the opposite. Congress has come up with a plan to encourage the consumption of fuel, while discouraging income, jobs, and economic growth.

GUZZLING

We have to admit to being surprised (OK, stunned) by the American consumer's indifference to \$3 gasoline. Lower demand was always a key component of our (Economics 101) thesis that the laws of supply and demand would roll back the price of oil, after its price had *quintupled* in less than a decade.

Of course, the price of gasoline barely tripled. After a lot of wailing and gnashing of teeth, drivers willingly lined up their ever-larger vehicles at the pumps. Everybody talks about Chinese demand, but in the past year *our* oil consumption went up by 500,000 barrels a day. China's went up just 400,000 barrels.

You can bet that the Chinese will move more aggressively to dampen demand than we will. Yet the biggest surprise of 2007 was President George "We're addicted to oil" Bush's call for a reduction in carbon dioxide emissions. After the Congress gets done with him the primary result will be new CAFE rules, and a Rube Goldberg "Cap and Trade" system that picks winners and losers, involves government in business, and puts a bigger dent in economic growth than in CO2 emissions. Even so, it's clear that we're experiencing a sea change in the nation's attitudes towards energy conservation.

The very best reason to slash our (careless and profligate) consumption of oil is that our dependence has boxed us into a weak and risky position on

the world stage. The current price of gasoline does not include a long list of "externalities" such as national defense expenditures and pollution. Gas-guzzling pickup trucks finance terrorism, and the entire world knows that we could not possibly follow through on a threat to blockade a rogue nation's oil exports.

The surprising truth is that—with today's technology—we could eliminate the use of oil. In the last issue of Insight we argued that the best way to power the nation's cars and trucks is to charge their batteries with power derived from nuclear plants. We can also fuel them with biodiesel, or with diesel derived from our limitless supplies of coal.

No one is likely to care, as long as gas costs just \$3 a gallon. Thus it's easy to say that the demand for gasoline will keep growing; and the rest of the story is that the supply of oil will match it stride for stride. Remember that the price of oil quintupled, causing an acceleration in the pace of oil exploration that has

“...at this speed the tyres will only last for about 50 minutes. But that's OK, because the fuel runs out in 12 minutes.”

--- a reporter at the wheel of the 1001 horsepower, 253 MPH Bugatti Veyron, in the DailyMotion TopGear Challenge.

turned up 5 billion barrels off the coast of Cuba and 200 billion barrels in Iraq's western deserts. The reserve estimates of other nations are expanding, as they become confident that oil prices will stay above \$40 long enough to justify the use of advanced extraction techniques. OPEC has already been forced to cut production.

In March we received a fund-raising call from a Texas-based oil and gas drilling firm that was working a list of money-management firms, looking for investors. That's one more sign of a bubble. Oil-partnership investors have reason to worry about the shrinkage of the Arctic ice cap, which is opening up vast new oil reserves at the top of the planet.

Gasoline prices are headed lower, and our oil consumption will continue to grow. The wild card is the Congress. What we need to do is raise the price of gasoline and other fuels to include all their external costs, but what we'll probably get is a mishmash of laws that shovel money to farmers and other special-interest groups while punishing automobile companies, utilities, and other corporations chosen at random by grandstanding populist politicians. As they stomp around in their hobnailed boots they'll inadvertently crush the best of the alternative-energy industries, and snuff out the dreams of their entrepreneurs. Be very afraid.

John Lumbard, CFA

Performance Results:

The performance results presented below are for our “Benchmark Account”, using January 1, 1998 as the date of inception. The performance results for the Benchmark Account are calculated by Lumbard & Kellner, LLC’s current custodian, U.S. Bank (prior to 2004 State Street was the custodian). The account pays fees based on our firm’s fee schedule from the 1990s (top rate of 1%), and the percentages shown are net of fees and expenses—that is, the returns shown would have been higher if fees had not been deducted. The performance results for the Benchmark Account include the reinvestment of dividends and other earnings, but there have not been any other additions or withdrawals since inception. The comparative indexes shown are the S&P 500 Composite Index, Dow Jones Industrial Average, NASDAQ Composite, Barclays U.S. Aggregate Bond Index, and the Citigroup 3 Mo T-Bill Index.

Actual returns for individual client portfolios managed by Lumbard & Kellner, LLC may vary and will not necessarily coincide exactly with the returns for the “Benchmark Account.” Past performance of the “Benchmark Account” does not guarantee future results. No assurances or guarantees can be given or implied concerning future investment results for Lumbard & Kellner, LLC or any investment index. Future returns may differ significantly from the past due to materially different economic and market conditions and other factors. Investments within portfolios, and therefore, portfolios, involve risk and the possibility of loss, including a permanent loss of principal.

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