February 19, 2004

"Ain't nobody ever made no money in bonds?"

Eleven years ago I traveled to Baltimore at the request of a friend, who at that time was managing the local office of Legg Mason. He had asked me to speak with some of the people in their home office. It was an uneventful trip with one exception. I requested a meeting with a man whom I shall call Haggis. He was very successful and one of their firm's largest producers. Haggis had started as a broker and eventually moved on to managing accounts for individual investors. What made him more remarkable was the fact that he was 91 years old and rarely missed a day's work. Emigrating from Scotland in 1926, he entered the brokerage business just in time to endure the 1929 crash and the subsequent great depression of the thirties. I rode the elevator to one of the upper floors and was ushered into his office, where I took my seat across the desk from him next to a window overlooking Baltimore Harbor. "For your clients who are retired," I asked, "how do you decide what percentage to put into bonds?" He glared at me as if regarding a fool. "Bonds! " he yelled (like "bond" was a four letter word), "Son, ain't nobody ever made no money in bonds!" Haggis continued in his heavy Scottish brogue, "Stocks, stocks, stocks is the only way you'll ever make money for people." In the end, Haggis and I actually had a good discussion about his strategies, and the hour spent with him made my entire trip worthwhile. I was, however, careful to avoid any further references to the subject of fixed income.

While I don't share Haggis' adamant hostility toward bonds, I do believe that the road to increasing one's wealth is paved with equity investments. Simply put, equity is ownership in assets that tend to increase in value over time. Real estate, works of art, commodities, other types of tangible investments, and well selected stocks all fit into this category.

In truth, most bond investments, over the last decade, have held or increased their value, while simultaneously paying a reasonable return. This is not to be scoffed at, but I do think, given the current economic climate, this is not the time to consider long-term bonds as viable investments. As you know, the last decade was a period of falling interest rates, which is a perfect environment for bonds, but I am of the opinion that the decline in interest rates is just about over. This is not 1990, and I believe it is likely that interest rates will begin to work higher for the following reasons:

1. The U. S. budget deficit will hit a record $477 billion this year (*projections released in January by the Congressional Budget Office*). It is difficult to see how the government can avoid large-scale borrowing, or how the Federal Reserve can avoid creating money to accommodate these needs.

2. The Commodity Research Bureau Index has risen from a low of around **190** in January 2002 to a January 2004 high of **270** (it is currently about 265). When this index of commodity prices continues to rise, we are almost certain to have inflation.

3. Americans are borrowing money in record amounts. We need money for those SUV's, big screen televisions, and vacations.

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In early January, the Federal Reserve release of Consumer Credit as of November, the latest reporting period, showed consumer debt crossing $2 trillion for the first time ever on a non-seasonally adjusted basis. This represents a doubling of America's consumer debt in less than ten years. Robert D. Manning is a leading expert on the credit card industry and author of the book, "Credit Card Nation: The Consequences of America's Addiction to Credit." According to Manning, about 40% of the people who hold credit cards pay their balances in full each month. This means that the remaining 60% carry balances continually, and the average debt of these people carrying balances is about $13,000. Applied Income Sciences in San Francisco states, "The average American now spends 18.1% of their disposable income servicing personal debt."

There is much discussion and debate among economists as to whether we will experience deflation (partially caused by the inability to service or pay down debt) or inflation, but I am betting on the latter. I believe our government will choose to reflate the currency rather than risk deflation. In fact, the dollar has been falling for several months now. Deflation means loss of jobs and a slowing of the economy and, politically, it is suicidal. If I am correct, it does not necessarily mean that interest rates will begin to rise tomorrow. Keep in mind we are a huge and very complex nation and long term changes in the economy are just that - long term. If I am correct on my interest rate scenario, it may still take a year or more for rates to begin to climb.

This correspondence is not intended to be pessimistic. We are simply discussing the inevitable cycles, which occur in capitalism. We experience inflation, then deflation, rising interest rates, then falling interest rates, robust business activity, then periods of rising unemployment. People run up debt, then go through the belt-tightening process of paying it down. It is up to all of us to do our homework, make a determination as to what cycle we are entering, and then invest accordingly.

Stocks of companies, which have an ability to pass along price increases, can grow and often times even flourish in an inflationary environment. Our responsibility to try to help you find those companies, invest appropriately, and do our utmost to help increase your wealth.

Sincerely,

Mike

J. Michael Hard
President

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