VIS A VIS
INVESTMENT COUNSEL INC.

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“Unconventional observations for unconventional problems”

An array of financial minefields is strewn over time and space. The regrettable conclusion, after giving some thought to such problems, is that all investors worldwide will be adversely affected. What adversity? In many cases, some of the undesirable attributes of <u>un</u>successful investments: loss of money, drop of a few notches on the billionaire scale, lose or impair nest-egg, house, job, car, perhaps even a dream or two.

Conventional thinking and conventional investing are not the solutions to our unconventional problems. That many do not, or refuse to recognize this tenuous environment, is a detractor to the solution; *The Montreal Accord (a Canadian manifestation)*, creeping bank-write-offs, off balance sheet icebergs, hedge-fund dooms-day-devices all attest in some form or another to a ‘laisser-faire’ predisposition.

The problem is that some of the financial excesses and abuses are blowing-up and now threaten the structural viability and the backbone of the World economy; banking and insurance sectors. Unfolding real estate problems are in many manifestations, terminal.

The subprime problems and contagion effects are an example of “mine-blowups.” They were invented by well-meaning Financial Engineers looking to transfer risk and increase returns. Too much was structured, emulated and mass-copied by most capital-pools and now, after the systemic Event, during this Great-Unwind, a more accurate form of risk-management is being applied.

The Media has reported on abuses where these instruments-of-destruction(mortgages) were pushed-on to unqualified and uninformed homeowners by devious, intellectually, ethically and morally challenged professionals who made out 'like bandits' during the distribution and risk transference process.

It is the USA subprime experiment which <u>ignited</u> a worldwide credit crisis. The systemic effects of this lab explosion are reverberating across all industries, political agendas and sociological boundaries.

Crash-Management remedies to date, for interrupted repayment streams:

- In Canada.... issue 'Denial-Notes' with phantom interest rate based, in part, on air 'The Montreal Accord'
- In USA....issue *price* controls, default controls,

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- In UK....encourage mergers, and short-term Government Nationalization solutions.
- In Switzerland, Germany, France...'Bailout' cash infusion headlines of the best known Investment Banks
- Insurance Companies: seeking assurances and reinsurance.
- Rating Agencies: reviewing imputative-methodology. 'Jam-Tomorrow' was sold today.
- Municipalities, Learning Institutions meeting with grave funding ineffectiveness.
- Worldwide, Central Bank Liquidity infusion in a magnitude and frequency that is unparalleled.

Result to date: Worldwide Credit Crunch[1].

A commodity super cycle which seems to be emerging, along with inclement weather, now threaten bouts of famine in geographies on which Western Economic growth is dependent. Sixty percent of the world's central-bank reserves are held in the $USD. All would have been uneventful had the USD not collapsed or threaten to continue a path towards the implosive side of a decay-function.

Well, there is no wand to magically make these problems disappear. But there is a prerequisite to any solution: One must first be aware that a problem exists.

An increasingly popular asset class that is emerging, is the SPAC [Special Purpose Acquisition Corporation]..."where investors place their cash with an acquiring entity based almost entirely on the reputation of the SPAC managers to find suitable investments by creating a liquidity/going-public event for privately held concerns." Here, the previous Hedge-fund algorithmic black-box morphs into a human interface black-box decision making mechanism. [algorithms work reasonably well with recognizable inputs but are unreliable during unconventional times] At least, with SPACs, a human being is taking the reins (the computer mouse). Structure, still remains opaque, with little room for oversight by regulators nor by the investor. Another adventure is unfolding.

The first *derivative*-experts on record may have been those who tried to *derive* Gold from Lead. Modern-day geniuses have structured financial instruments that attempt to extract value through the use of leverage and cleverly worded promises. As a simplified illustration: A piece of paper represents ownership of 1,000 oz of Gold and you can own it today by paying 5% now and promise to pay the balance later. So, what happens when more paper-gold is sold in this fashion than exists in the safety of the vaults? If you cannot find or dig it up fast enough to honor the delivery obligation, then the price of this commodity rises rather noticeably. A parallel exists now with the price

[1] **America's economy risks the mother of all meltdowns** http://www.ft.com/cms/s/0/1dc47bb6-df56-11dc-91d4-0000779fd2ac.html

of Wheat (Minneapolis) where the wheat price has increased four fold, palm-oil, Crude Oil…

Hedge-Funds have grown in number to about 6,000 and also in importance, as measured by how much of the World's wealth is controlled by these Botanical Garden caretakers. How are they investing your money? Cleverly, you HOPE. Who funds these investment entities? Ultimately, it is the Banks. A very small part is funded by private equity, 5-10% typically. Abuse of leverage within this asset class, if caught off-side, will make the subprime crisis and its manifestations, seem more like an off-wine and cheese cocktail party. At the extreme, I suspect that some algorithms may at times substantiate the cutting of a giant Redwood to plant an acorn. Guess how long investors will wait to see their capital? (Pension Funds, with ongoing capital infusions, do not share the same perspective as an individual investor).

Outlook: pressure on bank revenues, Pressure to their balance sheet, anticipated re-engineering and further 'bailouts.' Trade-routes being re-drawn, Savings being depleted.

Who loses, who gains? everyone: Cash at risk if in wrong currency and wrong Institution; All Asset classes to be revalued Worldwide at an accelerated rate. The rules of engagement have changed.

Solution for the investor? Bunker-down, also financially. (Hard-hat and some gravol may help. Otherwise, a financial-mine-sweeper and shark-repellant may help.) Moderation, successful diversification and uncommon sense should do the job.

Solution for the Governments? please provide your phone number and a receptive and effective listener.

Current mantra: Return-OF-capital more important than return-ON-capital. The guiding motivation when seeking a decent return on your capital is that this Capital is indeed returned. Low equity allocation, government bonds with short durations, and effective diversification is encouraged.

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At the suggestion of a helpful proof-reader, a more precise menu is put forth of what the investor can do to better navigate through the adversity that is anticipated- i.e. "where they can hide?" As each person and investment mandate can vary to important degrees, a more general deployment of financial-assets is put forth, but with enough specificity to perhaps still remain useful.

**** (please note the disclaimer included below)**

A more precise suggestion for the performance-oriented[2] investor is to :

Sell most Equities to hold a maximum of 30% exposure. 10% North America Indexed, 9% Resource(including Agri), 3% Europe, 4% for special situations which are presented at least, weekly and 4% physical Gold.

Remaining 70% to be in CASH and short-term(less two yr) GOVERNMENT Bonds.

Home currency: 40% (unless you live in Nigeria....), 5% Canada, 5% Aust+NZ, 8% Japan, 12% USA.

If the 'Great-Unwind' materializes the next twelve months, to deploy Cash war-chest first to current positions(i.e the 30% now held) and then to any of the Large-Cap ETF types....leaving 5% for the small-cap which would be then trading possibly at 25 cents to today's dollar.

Toughest decision is to get into cash....opportunity loss, quarterly reviews, and that few appreciate the alarmist....until the 'slaughter of the lambs' materializes. Well, I am not the Alarm, but rather an observer where the sound and smell from unfolding events woke me up rather rudely.

Equity Mutual Fund managers may indeed be bearish but must maintain fully invested Funds until they receive redemption instructions from their clients. I think those will come in due course and maybe in the form of an avalanche.

I think that over the next few months, through to the new USA administration, the wind-down of the China Olympics, and the Wars that seem to be poised to reignite in the Eastern-Block, along with the current financial upheaval, denial may remain the stance to many. We find that action, would be less destructive to capital.

Professionals and investors should review their asset allocation thresholds, stress test them for calamity and fine-tune as needed, question sector allocations, currency concentrations, Geographic diversification and get an answer to the toughest of questions: "Please, once more, repeat to me why am I in this stuff..." and if you don't understand the answer, then run for the hills.

[2] Simplified definition of 'performance oriented': **non-diversified** portfolio seeking absolute short-term returns.

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As clarified to one of my proof-readers, I do not “predict an end”....but rather the new beginning; All beginnings have some associated pain. I have great confidence that ‘smart people will continue to make dumb mistakes’, some painful and others surmountable. If my allocation is too alarmist, consider how much phantom-profits will be lost? If I am correct, how much money will be saved? How much of your portfolio represents your life-savings?

Some pretend to know the future. All Economists present valid and realistic expectations; however their assumptions may be flawed or lacking in accurate inputs. What I found helpful prior the 1987 crash and the Dot.com bust, was to have accepted the opportunity-cost of not being fully invested. A workable idea is to take a snap-shot of sorts of the portfolio prior to the determined and strategic liquidation, and then repurchase more or less, the same positions when the time seems right.

The portfolio modification put-forth above, presupposes a global economic slowdown. If Governments however, continue to fuel an inflationary course of action, then the suggested 70% cash allocation may prove damaging. More conservative[3] investors can chose to be less aggressive and allocate 50% exposure to Equities. 14% North America., 15% Resource(including Agri), 5% Europe, 10% for special situations which are presented at least, weekly and 6% physical Gold.

Few of the clients we advise have stated that their investment-goal is to make obscene returns on their portfolios; rather, if we help them make 3x more than what they can earn at the Bank or 2% after tax and after inflation, our mission would be accomplished. However, the clients we advise have shared with us the displeasure of losing capital. At this we have succeeded; none of our clients have lost capital. During good markets, we have even excelled. Subjective risk-adjusted returns and constant currency returns are qualifiers that have gained importance in how we now evaluate our work. I know this also holds true for anyone else who invested in USA securities during the last four years.

John Evdokias

PS. Stop spending money you don't have!....is another good advice. Also reread about the Great Depression...Mr. Bernanke surely is reviewing his thesis notes.

NB: It is important to note that any securities mentioned within this communiqué should not be construed as a recommendation from Visavis Investment Counsel Inc. nor the author.

[3] Simplified definition of ‘Conservative’ is an investor seeking a balance of **long-term** growth and capital preservation.

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