VIS A VIS
INVESTMENT COUNSEL INC.

Client Communiqué: May 28, 2009.

"Investment environment and your savings"

A hopeful observation: "We may have averted a catastrophe, but how do we get a real recovery?"[1]

The last two years, investors have been witness to dramatic, and for many, unforeseen and undesirable economic events. During this time, we strived to deal effectively with the Fear and Panic prevalent in the market place; now we must deal with manifestations of the problems and the painful implementation of a plethora of experimental cocktail solutions being embraced. As most of the issues are new, policy makers can only apply untested remedies: Result: crisis management, trial-and-error methodology and an incessant determination to find workable solutions (ones that will set things right again).

It may be helpful to the reader that we raise some questions we find pertinent and try to constructively answer them within this report to you. (You may have other questions of your own and we would be pleased to attempt to answer them.)

> "Do you have any doubt, that the world is in an economic Depression?"
>
> "What can go right?"
>
> "Is there a fix? How do we get an economic recovery?

These questions, and probably other worthwhile considerations, if addressed properly, will help anticipate the likely effects of this current capital-markets anathema. We 'pretend' to have a good notion of what is happening and what must occur (different from pretending to know what will occur). In previous reports to you we had outlined the neglected and unsupportable issues that ultimately brought us into this inhospitable economic environment. The goal of this report is to set out some of our forward looking expectations, ones that can perhaps better help you understand our investment thought process and attempt to explain the difficult investment environment the world is still facing. (Individually, we can review the historic events and causes but for the purpose of this communiqué, we find that looking ahead may prove more productive and more useful; mostly, the culprit was a gross, and perhaps criminal abuse of leverage)

Last autumn, the Financial System (the arteries that carry money flows) came within a few hours of a global collapse; Money stopped flowing within the Banking system, which is also the de-facto, life giving cash-flow artery of the Capital markets and the financial world as we

[1] Paul Krugman (Nobel laureate)

know it. To characterize the crisis further, confidence was shattered as was trust, especially by informed financial intermediaries intertwined within our counter-party system. It did not help that inexperienced 'video game' financial-wizards panicked and seized-up on all decisions, much like a deer freezes on the spot when you shine a light in it's eyes; do nothing, was the manifestation…and trust no one, not even your own judgment.

The US government was in the process of changing leaders, Presidential Advisors and Policy initiatives. Thankfully, the crippling chaos was not mishandled through the transfer of power and the new government proceeded to make effective changes. The "catastrophe was averted" and some measure of a fragile-stability now seems to exists.

Instilling this confidence came at a gargantuan cost; questionable Government guarantees, Trillions of dollars of seemingly indiscriminate[2] spending(bail-outs), 'nationalization' of many Banks and industries, and an accelerated deleveraging process. It is this unstructured and accelerated de-leveraging that was instrumental at unraveling the capital-markets (stocks, bonds, currency, real-estate) resulting in 50% or so drops in the stock markets and a destruction of wealth in the World estimated last January at about USD $100 Trillion[3]. [in magnitude, about *seven* times the GDP of the USA or 2x Gross World Product]

The social cost to date? Undulating waves of unemployment worldwide, redrawn trade routes, civil unrest (riots), middle-class implosion, wars, famine, poverty. The indiscriminant spending by the US government, of money they don't have, will create another untenable predicament. Is there a choice? No. Basically, a huge part of that absurd and abused leverage we spoke of, is now being supplanted by the USA government efforts to spend its way out the 'depression process.' Other counties are also adopting such measures. I expect a 'Newer Deal' may be presented to the world by the USA (or a reciprocal overture; i.e. others will impose changes on the USA), one that will redraw(rethink) key attributes of the reserve currency status of the USD. Perhaps USA may soon need to raise money in other currencies than the USD to fund their future spending requirements? The USA has never defaulted on paying its USD debts; however, they have unilaterally changed the guarantees backing their currency. (Bretton Woods 1971). I also remember reading[4] that USA Department of the Treasury(or Department of the Currency), about two decades ago, passed legislation that permits the creation of a 'blue dollar' if need arises. At the time, the concern was to fight counterfeit efforts and criminal cash-activities. Well?

A Depression is not a moment in time, but rather, it is a process. (my observation)

I think we are well within this process. When the layoffs stop, and we start seeing positive employment numbers, then we can speak of a recovery (those green shoots imagined and reported everywhere) and of making up lost ground. Thankfully, policy-makers are also keenly aware of this determination and all efforts are directed to avoiding the 'Greater Depression[5].' In other words, when will the recovery come, how long will it take, and when will we regain lost ground? Here, I raised some new questions that are beyond my capability to answer effectively and maintain credibility. (Most of the media and financial soothsayers do

[2] Indiscriminate:' printing of money 'is no longer limited by availablility of ink; money is now created electronically.

[3] Notional value of derivatives 'out there' estimated at USD$480 Trillion; room for more damage.

[4] "Blue Dollar" Sorry, but I cannot find the original govn't document I read twenty years ago.

[5] Depression: "20% plus unemployment. [Spain, France already there, USA at 15% non-adjusted." j.e.

have <u>in</u>credible answers to these questions and are as inventive when they apply them to advising or investing 'other-peoples-money'.) At best, we offer some hopeful answers that are by all means, uncertain. Succeeding at this high-wire-act will come at a great cost: Inflation. I also think that this is the only 'fix' for the economic Depression at hand.

Near zero interest rate environment? That is what most banks offer for your cash deposits. I estimate that Cash liquidities at best earn a negative 1.3% return after tax and after inflation. So where is inflation evident? Perhaps it is the wrong term; destruction of purchasing power may be a more appropriate description of what is facing USD holders of cash and Longer Term Treasuries. [does not necessarily exclude other country currency] Ask Icelanders about the decay of their currency; joining the already bogged Euro-bloc is the solution considered.

Last year especially, we managed to navigate through very adverse markets and succeeded in maintaining clients' savings intact. What now? An illustration may help:

> Two investors A and B; Investor A was fully invested in the stock market and lost 40% on their stocks in 2008 during the market collapse. Investor B had more balance in their allocation and being only 45% in Stocks, lost say the same 40% on their stocks (Visavis stock portfolios performed noticeably better). The more prudent allocation decision somewhat protected investor B as their total portfolio in this example lost 18% during the Crash while investor A had the full impact of the market collapse and lost about half their savings.
>
> Investor A waits and hopes for a recovery of the portfolio while investor B, who still has 55% liquidities can now opportunistically purchase some very much undervalued securities. Investor A will regain their capital when the markets advance by 67% while investor B will need a smaller advance in the stock market, i.e. a 22% appreciation to gain back their capital. Another keen lesson (re)learned by many is that all stocks are risky. Managing this risk is where the competent professional can often add more value.

Maintaining some cash liquidities is still warranted. (Home-currency practical considerations are assumed.)

"A low risk, diversified portfolio, of blue-chip Bank stocks" no longer holds the same meaning for an investor nor for the typical advisor. The world has changed as have perceptions.

The press? Well, the few that are not lazy or otherwise in conflict, still do a decent job at regurgitating history, vested interest group disseminations, and capturing headlines. After being provoked by reading a silly press item recently, from a reputable publication, I was inspired to write a 6-word-story[6]:

"Overestimated intelligence does impress underestimated stupidity!" j.evdokias

[6] (as defined and exemplified by E. Hemingway)

In a similar manner to Investor B and where appropriate, we have already opportunistically increased your equity holdings through this market collapse. The improvement in markets since March is welcomed but is way ahead of the reality that is facing this economy.

Europe is now also experiencing a material slowdown in business activity; some Baltic[7] nations may leave the 'EU bloc'; USA is quick-fixing their trouble by borrowing their way out; China has no trouble officially, except for their distracting investment portfolio in US-Treasuries, customers in a world economy on the verge of collapse and half a billion disillusioned, reformed peasant-capitalists that may soon seek a culprit for their malaise. China's growing economy is suggested to be a big part of the remedy. If you consider that California's GDP is twice the size of China's, it suggests that changes must also be made in North America. Ireland, Belgium, UK are on the verge of collapse; Governments which previously recorded surpluses are now generating deficits. [Canada]

So, what has else has changed? Consumers are now curbing their wild spending by necessity or choice; Credit is again becoming a privilege not a right, Return of capital is no longer an assumption but has become a forefront calculation; the comfort of a sovereign guarantee has lost much of its cache, one government bail-out after another…which reminds me of an impulsive, timely and perhaps morose recent attempt at poetry:

"Last week I started writing on Bailing out the Titanic.
On Sunday I began again under a modified title Bailing out the Bermuda Triangle
Today I realized that I don't need to bail out anything else, for I am about to drown.
Gulp!"

J.E. . September 17, 2008.

'Common cents, uncommon dollar': "Smart people do make dumb mistakes"—that so many smart people made the same dumb mistake is noteworthy; just ask any pension fund administrator now relegated to dealing with disaster management and their screaming casualties, the pensioners. What transpired within this industry is unfathomable and was unnecessary. To illustrate, please consider the excerpt from a dated, Visavis email to the Office of the Superintendent of Financial Institutions (OSFI) provided for you in Appendix 1.

US Government's trillion-dollar plus bailout program for toxic paper: I think the approach of having Hedge Funds(HF) administer the process will prove as explosive. What will later add further injury, once the HFs repackaged these 'mines' under the new umbrella, this new '3-ply commercial paper' (same *3-ply* we all use) will once again, find its way into the public coffers; directly or indirectly through the pension funds and other captive audiences. This HF cleanup is a bit like how Defence companies sold and deployed millions of land-mines and then were paid to clean up the mess they created and propagated.

[7] "possibility of a multiscale Baltic devaluation and a sharp CEE sell off in the wake." http://clausvistesen.squarespace.com/

Summary:

However hopeful I am that there will be an improvement, time, and then more time is required. Here are some developments which must occur:

- Stability and confidence must return to Banking.
- Confidence must return to the investor.
- Consumer must start spending again.
- Investors(business, pension, individual) to adopt more realistic expectations.
- Business must think and apply strategies longer-term.
- Protectionist impulses must remain in check.[8]
- Crooks, liars and cheats must go to jail.
- Laws must be rewritten to better protect the investor.
- Incompetence must be flagged to protect the unsuspecting and innocent.

There is evidence that some of these desirable and transformative changes are occurring.

In summary, diversified portfolios by Geography, Industy and Asset class will generally do a good job at keeping your savings intact and will offer decent growth during good economic climates. The last few months you may have already noticed your portfolios invested in some ETFs[9] of European and Asian Equities.(Geographic diversification) Engaging in call-option covered-writing, as we have done where appropriate, will also increase the income generated by your portfolio.

You already know that currency is an important issue as is the economic reliance of Canada to the USA. For this reason, within your American component, owning US equities is preferable to owning US bonds or USD cash; a higher weighting to resources will also help address the future inflation we anticipate will become a cornerstone issue again. The goal is to preserve the purchasing power of your savings.

As stated earlier, keeping low USD cash and low or no long-term Fixed Income positions may be the prudent decision; with USD liquidities, investing in quality hard assets, equities, and other 'inflation friendly' assets are the preferred choices. Gold ownership is still encouraged[10].

In general, a valid adage, that of 'owning Equities of a country whose currency is depreciating and Bonds of the country who's currency is appreciating' will do a decent job. If we are correct, and interest rates increase materially (i.e. 10 year yields to increase at least two fold), we can then consider to deploy more of your highly liquid Fixed-Income component into longer maturities within your portfolios. (At that time, I expect that stated inflation will also be much higher.)

Visavis Investment Counsel Inc.
(Advisors to Discrete and Discerning Investors)

[8] 'protectionist elements': Not every country can try to export their way out of the economic slump as Japan had done. Who will lose out?

[9] ETF: Exchange Traded Fund

[10] **Insurance company makes First Gold Buy in 152 Years (please see appendix 2)**

Appendix 1

From: John Evdokias
Sent: Thursday, May 07, 2009 1:46 PM
Subject: Pensions: How a good plan went bad" .....'how a bad plan went bad' j.e.

“...The stakes were simply becoming too large to leave the responsibility to part-time management,” he explains...
...The university's pension fund had 46 per cent of its assets in this “alternative” category at the end of last year – up from just 18 per cent the year before – while equities accounted for 39 per cent of the holdings and bonds 15 per cent....
...And now, the very existence of one of Canada's most innovative investment funds is in question by the university that is bearing the brunt of its losses.."

> *http://www.theglobeandmail.com/servlet/story/RTGAM.20090507.wrutam07/EmailBNStory/Business/home*

Probably accurate but part time management may have been better than full-time mismanagement. This deplorable and damaging wealth destruction should never have occurred. Disregarding prudent investment mandates in favour of beta-testing hedge-fund black boxes, along with failing at proper allocation of assets did them in...many more to follow I expect.

Undisclosed, unrealistic assumptions, a poor manager selection process and perhaps some structural conflict of interest issues are also culprits. Would you still seek the advice of your Doctor, one who misdiagnosed your situation, and unnecessarily cut off one of your limbs? Well, the same 'doctors' are still giving advice to their pension patients. I suspect that admitting to a 'judgment error' may be perceived as more damaging to the decision makers than the losses. Put a face behind the loss, and then you will see how quickly that mis-perception changes.

Most professionals hide behind the usual and overused excuse; "Who would have anticipated this anathema?" Well, some did; not because they are more clever, perhaps a little wiser, but mostly because they considered the abnormal area of a distribution of likely events. I think that working with only 68% of expectations (i.e. normal distribution) has proven to be imprudent.

The 'need for greed' was surely espoused and propagated by the generous incentive fees paid for out-performance and the lack of a better defined accountability and responsibility guidance. Out-performance goals are linked to higher risks. Was it the intention, to take higher risks with pension money? Six years ago, we wrote to the Nick LePan at OSFI about such problems facing the pension industry and the need for more robust guidance.

an excerpt:

> *“...Decisions taken now are part of the stress-test we are undergoing, from which our financial system must soon graduate. In stakeholders, I would include all who have pensions or are affected by purveyors of services to this sector. Wonder if that leaves anyone out? Your work and effort is central to the livelihood and peace-of-mind of generations to come, so please get that across to the vested interests you regularly interface with these days and if you can, to Cabinet members also. XMXMXM is not the issue; the financial well being of ALL Canadians is the issue.*
>
> *Investing of pension money must be more clearly delineated and presented more clearly to the public. Perhaps a reform to the previous-reform is again necessary? Probably an ongoing process. Maybe if money-managers and corporate executives, are in the future made personally liable for disastrous investment decisions, it will assure that all pensions become and remain fully funded*

What to do? Continue to be fair, equitable, flexible, and patient, but remain unwavering to threats to the Pension Fund integrity.(you won't be popular) The Cabinet? They also require a clearer understanding of the issues and risks, free of vested interest lobbying." .... Visavis 27Oct2003

Result? Whistling in the wind, albeit, more gentle than usual as I got a response and spoke with someone at OSFI.

APPENDIX 2

Northwestern Mutual Makes First Gold Buy in 152 Years ....By Andrew Frye
June 1 (Bloomberg) -- Northwestern Mutual Life Insurance Co., the third-largest U.S. life insurer by 2008 sales, has bought gold for the first time the company's 152-year history to hedge against further asset declines.
"Gold just seems to make sense; it's a store of value," Chief Executive Officer Edward Zore said in an interview following his comments at a conference hosted by Standard & Poor's in Brooklyn. "In the Depression, gold did very, very well."
Northwestern Mutual has accumulated about $400 million in gold, and Zore said the price could double or even rise fivefold if the economy continues to weaken. Gold gained 10 percent last month, the most since November. The commodity has more than tripled since 2000, rising for eight straight years. Gold futures for August delivery slipped $4.80 to $975.50 at 4:03 p.m. in New York.
"The downside risk is limited, but the upside is large," Zore said. "We have stocks in our portfolio that lost 95 percent." Gold "is not going down to $90."
Policyholder-owned Northwestern Mutual, based in Milwaukee, ranks third by 2008 life insurance premiums according to data from the National Association of Insurance Commissioners. The data excludes annuities.
To contact the reporter on this story: Andrew Frye in New York at afrye@bloomberg.net
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http://www.bloomberg.com/apps/news?pid=20601087&sid=ajf0L9wTPq6Y&refer=home

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Northwestern Mutual: Less Risk in Gold

By Carrie Burns June 1, 2009
Northwestern Mutual Life Insurance Co., Milwaukee, has bought gold for the first time in 152 years to hedge against further asset declines, Bloomberg reports. According to the news service, Northwestern Mutual has accumulated about $400 million in gold, and CEO Edward Zore says the price could double or even rise fivefold if the economy continues to weaken.
"Gold just seems to make sense; it's a store of value," Bloomberg reports Zore saying in an interview following his comments at a conference hosted by Standard & Poor's in Brooklyn. "In the Depression, gold did very, very well."
Just last week the greater press reported that U.S. gold futures are up, supported by a combination of a weakened dollar, inflation concerns and simmering geopolitical tensions. Gold gained 10% last month, the most since November.

"The downside risk is limited, but the upside is large," Zore says. "We have stocks in our portfolio that lost 95%." Gold "is not going down to $90."

http://www.insurancenetworking.com/news/-12422-1.html