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Investment Newsletter – December 2008

Time to Look at Converting your IRA into a Roth IRA

There is a silver lining to your losses in your Individual Retirement Account (IRA). You will pay less in taxes to convert it to a Roth account. If you qualify for the conversion, I strongly urge you to convert as much as you can afford to pay tax on - as soon as possible.

The difference between a Roth IRA and a traditional IRA is that you pay tax on withdrawals from a traditional IRA but no taxes on money taken out of a Roth IRA – once you are retired. For 2008 you can convert money into a Roth IRA if your adjusted gross taxable income does not exceed $100,000 and you do not file as married filing separately. For some people this income limit eliminates any chance of the conversion. For some, it might make sense to accelerate deductions to get under the 100,000 limit so as to qualify for the conversion. When you do convert you must pay tax on the amount converted. The tax is assessed by adding the converted amount to your current year income. Thus the cost of conversion is the value of the account times your marginal tax rate in 2008.

There are two factors which make this conversion strategically optimal right now. First is the fact that the value of most people's account has been lowered – thus decreasing the tax and increasing the likelihood of larger future gains in the account. The second factor is that it is extremely likely that income taxes in the U.S. will increase significantly in the next 10 years to pay for current emergency spending and the coming wave of (Baby Boom generation) social security and Medicare benefits. Contact Berkeley Investment Advisors if you need advice on how to maximize the potential returns after the conversion.

Avoiding a Madoff - style Ponzi Scheme

Recently the largest fraud of all time was disclosed in the media. Bernard Madoff, a famous and well respected money manager in New York, says he has defrauded his clients in the amount of $50 billion in a Ponzi scheme that he ran for decades. In his Ponzi scheme, Madoff provided account statements showing steady returns of about 1% per month that were not real. Whenever an investor asked for their money back or got too curious, Madoff would pay off that investor using money from other clients. This kind of thing can only work if no one can see the records of total assets and liabilities of the perpetrator. Another key is that Madoff had to be able to take money from one client's account and give it to a different client. Hence it is impossible for such a Ponzi scheme to work where a custodian who is independent of the money manager is keeping the records and controlling the movement of funds. Therefore separately managed accounts in the custody of a separate brokerage company, such as those managed by Berkeley Investment Advisors, cannot be so manipulated.

Madoff had complete control of funds and accounting records because he required investors to put money into his (co-mingled) fund. This is how the mutual fund and hedge fund industries operate. They pool people's money together in one account at a brokerage where trades occur and then they keep track of how much is owned by each individual investor. Thus statements come from the money manager not the custodian. The custodian does not even know who the ultimate owners of the funds are. In the Madoff case, he owned the brokerage company which was the custodian so there was no independent source of accounting information whatsoever. While it is possible to set up an accounting control system so that a third party is tracking assets and liabilities, it is not guaranteed to happen unless the fund is audited – which mutual funds must be by law.

The lesson here is that you must do your due diligence when you invest in a private fund, such as a hedge fund or private equity fund. Make sure there is third party accounting and an independent auditor certifying the accounts. Generally, registered investment advisors are subject to audit. Until 2006, Madoff was not registered and so his fund was not subject to audit. Even after he registered, the Securities Exchange Commission never got around to doing a proper audit despite having been tipped off that something was fishy in Madoff's reported numbers as far back as 10 years ago. Apparently, Madoff's reputation and connections were so good that he could avoid close scrutiny.

Economic Outlook

Housing wealth and stock market wealth in the U.S. has declined dramatically in the last year – prompting Americans to increase their savings to compensate. The flip side of this phenomenon, the drop in consumption, is the primary driver of the recession. Media driven fear is magnifying the effects as everyone delays large purchases or capital investment to wait and see what happens – a self re-enforcing downward spiral. As a result, the world finds itself with too much production capacity and deflation will be the short term consequence. Eventually price declines reduce supply and increase demand until we reach equilibrium. Only then can the growth cycle start again.

The new democratic administration plans to cushion (and lengthen) this adjustment process by spending a very large amount of money which they will borrow from foreigners. Indications are that they want to spend the money themselves rather than provide tax cuts or rebates for Americans. Thus it will take longer to get the money into the economy and it will be relatively inefficient in rebuilding wealth relative to the debt incurred. Still, it will cushion the economic decline in the second half of 2009.

As things improve and fear of a great depression recedes, the wave of dollars from the government and the Federal Reserve will start moving faster in the economy. This is very likely to lead to inflation and a weaker dollar.

Another Great Depression?

We can compare this recession to the 1930's only in the sense that it will be the worst downturn since that time. But unless the government and the Federal Reserve repeat the policy errors of the 1930's – such as erecting trade barriers – this downturn will not come remotely close to the severity of that time. The Federal Reserve chairman studied the errors of the 1930's closely and has shown that he knows what is required of monetary policy. Even by itself, such enlightened monetary policy can moderate the downturn even if the Democrats do everything wrong. Given Obama's economic team, they are unlikely to follow through on their most destructive campaign rhetoric. Thus, I expect the damage to the economy from this crisis to be long lasting but not nearly as severe as it was in the 1930's (25% unemployment and widespread poverty).

Our strategy for a market panic environment – A note to clients from 11/24/08

Although we have just seen a two day rally in stocks of 13.2% from the current market low set on November 20th, there is much bad news to come still. Because a continuing string of bad news is much worse for investors psychologically than one very bad event (like 9/11), I believe we will eventually see the market move even lower. Although Obama has given some indications that he could hold off potentially destructive economic and regulatory policies until the economy recovers, the crisis may yet inspire congress to push devastating policy responses like those which worsened the great depression of the 1930s. Until we see whether the government plans to help or hurt the economy, I think a more sustained rally is premature.

Despite my gloomy assessment of economic and market conditions, my optimism for our investment strategy grows as the market declines. Valuation declines for our positions are setting us up for amazing returns going forward. Our future returns seem likely to exceed the fabulous results I realized in 1999 and 2003 to 2006 (www.berkeleyinvestment.com/html/rays-returns.html). The table below provides key statistics for the two main (long position) portfolios:

As of 11/21/08:	Long Term Value Portfolio	Special Situations Portfolio	S&P 500
Price to Book Value	46%	13%	149%
Price to Earnings	3.2	1.65	9.2
Dividend Yield	12.0%	39.4%	3.3%

On a blended basis with our hedge positions included, the dividend yield is roughly 8%.

If the government didn't do anything except help recapitalize the financial system, I would be surprised if we didn't triple our money over the next 5 years. I could remove all our hedges today and we'd do great in the long term – but I realize the short term pain might be too much for my investors to ride it out. Frankly, I'd rather give up some upside for comfort of knowing that we aren't subject to further large drops in the market.

There are three components to my strategy in this market:

1. Own a high dividend portfolio so that we earn much higher returns than bonds while we wait for economic improvements to reduce risks of full equity exposure.
2. Invest in assets that provide inflation protection or even benefit from a rapid rise in inflation that will materialize as the financial crisis abates.
3. Insure against market wide declines in valuations using inverse index exchange traded funds to reduce volatility and provide gains to invest as markets decline.

The first component of this strategy provides us a roughly 8% return even if the market ends up staying flat for the next year or more. The second component positions us to benefit greatly from the most logical policy response in the U.S. –

increasing the money supply and driving up inflation and salaries to reduce the impact of the popping real estate bubble. The third component allows us to continue selling high (our hedges) and buying low (dividend paying stocks) even as the market declines and liquidity providers (like us) are paid higher and higher future returns to take the buy side of trades.

While I believe this is a superior strategy which is likely to produce amazing returns over the next 5 years, we are not completely immune to losses - despite our hedges. The current deflationary forces and the melt down in the bond markets have caused unusually large declines in stocks tied to real estate, gold, and energy. We can and should accept this underperformance in the short run because such deflation is highly unlikely to persist long enough to materially affect our long run results and because the factors causing these deflationary effects will be the main target for government actions.

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