

# Current Observations

FINANCIAL & INVESTMENT MANAGEMENT GROUP, LTD. • FEE-ONLY WEALTH MANAGEMENT

## 85% Employed



by Paul Sutherland, CFP®

I think it is quite possible that our unemployment rate could rise to 15% and our economy could be stagnant, with little growth for quite some time. The global economy will also be slow as it attempts to recover from the excesses of the past. Industries, countries, institutions and consumers went wild during the past 10 years, borrowing to finance everything from TVs to wars. The world was looking for immediate gratification. Respect for the future, rational common sense, and normal virtues of prudence and responsibility went out the window. As a result we find ourselves in a world today that seems like cause and effect, and the very institutions in which we put our faith have lost our trust.

Humans learn slowly, and we tend to create systems that are reactive rather than forward-looking. In 2005, the U.S. personal savings rate was negative, in the early '90s it was 8% and as of December 2008, we were around 3.6%. Just for a comparison, Germany and Japan save an

average of 10% ([www.cnnmoney.com](http://www.cnnmoney.com)). Many believe that we are evolving into a new state of frugality by reacting to the unease of today and reducing our budgets, spending less and saving more. But saving more equals spending less, which means our economy will continue to be slow. However, regardless of the slower areas we will have pockets of strengths and weakness. Banking, retail, consumer goods, autos and manufacturing will generally be swimming upstream with reduced demand and structural infirmities that need to evolve. Eventually we will get tired of our old car, take that vacation, and buy that new washer, TV or laptop. With consumer confidence at the lowest level in 40 years, it will take a while for the tide to turn. So in the meantime, what's an investor to do?

### Go Where the Action Will Be

At FIM Group we like health care, medical equipment manufacturers and pharmaceutical companies, which will most likely benefit from

### Why We Like Dividend-Paying Companies

S&P Dividend Yield and Future Stock Performance

S&P 500 Yield	6 Months	1 Year	2 Years	3 Years
Below 3%	-1%	-5%	-10%	-1%
3% to 4%	1%	4%	9%	12%
4% to 5%	7%	14%	21%	26%
5% to 6%	4%	11%	33%	56%
6% to 7%	6%	12%	32%	45%
Above 7%	8%	29%	42%	63%

Between 1926 and December 2005, 41% of the S&P 500's total return was due to the dividends being paid out.

An investment of just \$10,000 in 1926 held until 2005 without dividends would have made \$1,013,000, and with dividends (reinvested) would have netted \$24,113,000!

Source: Bloomberg, Standard and Poor's

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### Energy Companies We Like

**STATOILHYDRO ASA-SPON ADR** [www.statoilhydro.com](http://www.statoilhydro.com)

An integrated oil and gas company focused on exploration, development and production of oil and natural gas from the Norwegian Continental Shelf (NCS). It has business operations in 40 countries.

**ENI SPA-SPONSORED ADR** [www.eni.it](http://www.eni.it)

An integrated energy company, operating in the oil and gas, electricity generation, petrochemicals, oilfield services, and engineering industries, with operations in 36 countries.

**BP** [www.bp.com](http://www.bp.com)

Formerly known as British Petroleum, BP is the third-largest global energy company. BP and Clipper Windpower announced a 50:50 joint venture to develop one of the largest wind farms in South Dakota.

### Health Care Companies We Like

**LILLY** [www.lilly.com](http://www.lilly.com)

Founded by Eli Lilly in 1876, they are the 10<sup>th</sup> largest pharmaceutical company in the world. A leader in diabetic care for over 80 years along with manufacturing Cymbalta, Prozac and Cialis.

**PFIZER** [www.pfizer.com](http://www.pfizer.com)

The worlds largest research based pharmaceutical company founded in 1849, recently announced the acquisition of Wyeth. They manufacture popular drugs like Lipitor, Zoloft, Celebrex, Zyrtec to name just a few.

**MERCK & CO. INC.** [www.merck.com](http://www.merck.com)

Established in 1891, Merck discovers, develops, manufactures and markets vaccines and medicines to address unmet medical needs. Merck vaccines include Rota Teq for the rotavirus, Gardasil for human papillomavirus and medicines PROPECIA, SINGULAIR and VIOXX.

the 40+ million Americans President Obama has promised to bring into the insurance system. In addition, there are around three billion fellow world citizens who would like to have better health care, so the global health care industry has great prospects. And, "oh yes," as we live longer we create more demand for health care services.

#### Energy – We Need It

Energy is transitioning, and huge profits will come from those who see the opportunity in the change. Solar, wind, gas and renewable energy are the sources that are going to be a big part of our future. In addition, nearly every world leader has made a commitment to support their economy through infrastructure development, including enhancing and refurbishing energy, telecommunications, transportation and education.

The bottom line is that some areas of the global economy will prosper, and some countries will grow. There will be companies that are well-managed, with solid balance sheets that will come through the recession stronger, with less competition, as lean and strong profit machines.

What kind of returns should we expect from investing today? History shows that investment returns on stocks and bonds should be quite robust in the future. When many of the stock market indices in Europe and Asia have cash dividend yields around 6%, and many U.S. companies in good industries like pharmaceuticals and energy have 5% to 7% yields, you can see the rationality that future returns should be quite rewarding for the properly invested. Include appreciation and possible currency gains and you can see our thoughts are not unfounded, optimistic gibberish or forecasting fiction.

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Of course, this is not a “throw a dart and buy” market. There are a lot of investments that are toxic waste, but most of those are obvious.

A while ago I had the privilege of meeting Marcus Buckingham, author of numerous management books like *First, Break All the Rules* and *The Truth About You*. During his 15 years with Gallup he studied what made some companies great and isolated the management skills that seemed to work well. In his speeches Buckingham often references the “American parent” story, in which he talks about a kid who shows his parents his report card with four “As” and one “C.” “What do the parents chat about for the next two hours?” Buckingham asks. The “C,” of course. Buckingham says that in order

to succeed, get great people and find what they do great, and then have them do what they do great. That philosophy is no different for investing. Our portfolios are full of investments that we feel will do great in the upcoming economy. There will be inflation, currency instability, unemployment and deflationary forces, but there will be great areas in which to invest. After all, 15% unemployment means 85% employment. We get what we praise. Praise the “As” and invest where there is strength and opportunity. **F**

**“There is always a disposition in people’s minds to think that existing conditions will be permanent.”**

– Charles H. Dow, co-founder of Dow Jones and Company

## Credit Spreads – Crack, Gap and Chasm



by Suzanne Stepan, CFA®

**N**ot long before Christmas I decided to take up jogging. I am neither an athlete nor someone who likes to prolong my next suck of air. So why start jogging? I was speaking with a relative who is a long-distance runner, and she explained to me that it takes more than a year to become a runner. When I heard this it made me wonder what kind of runner I could be if I gave myself a year. I decided to take on the personal challenge, and starting from scratch I began to just run around the neighborhood.

I think about a lot of different things while I’m jogging, and recently corporate bond spreads were at the top of my thoughts. Due to the intensity of my near-crawl jogs, I only claim to ponder thoughts and dreams and not critique their relevance or application. This sort of thing happens when your lungs are burning beyond belief from near zero-degree temperatures, and your side is so cramped that it is scream-

ing, “STOP!” So just before I wondered if my trachea had collapsed from breathing so strongly, the reflection on corporate credit spreads weighed in.

During the later part of 2008, U.S. corporate bonds experienced a significant divergence in spreads. A spread is the difference in yield received on a risk-free bond such as the 10-year Treasury bond as opposed to the yield received on a corporate bond of the same maturity. For instance, the U.S. Treasury can attract investors with a lower yield, since it is presumed that the U.S. government has no default risk. Traditionally, the differential indicated the credit risk of the corporation issuing the bond and is used as a risk-management tool in fixed-income management.

Corporate bond yields are prone to move up and down based on fluctuations in the general bond market. The analysis of credit spreads is the element of the corporate bond yield that is above the yield of a comparable default-free

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## CREDIT SPREADS ... continued from page 3

Treasury bond. It is the excess interest rate earned by holding the corporate bond versus holding a similar U.S. Treasury bond to maturity.

The excess yield is only received if the corporation that issued the bond continues to meet its interest rate payment obligations and pays the holder the original principal amount back at maturity. The credit spread traditionally is an indicator of the financial health of the firm that issued the corporate bond.

When the world began to experience the global credit crisis last year, liquidity risk became a key component in the credit spreads of corporate bonds, and the liquidity premium, in turn, caused credit spreads to move from a gap to a chasm. Transactions for corporate bonds are far less than for Treasury securities. In addition, information on bond prices is much less transparent than on actively traded Treasuries. A premium is required by investors whenever a security cannot easily be converted into cash at the prevailing fair market value. When an asset is illiquid, the liquidity premium will be high. During a time when investors retreated and demand for holding corporate bonds waned, the credit spread widened even further as investors demanded additional compensation for holding securities that were less liquid.

Throughout the later part of 2008, it became highly evident that the liquidity risk explained a significant portion of the drastically expanded credit spreads. The size of the liquidity premium is established by the size of the bond issuance, the yield volatility and the number of years the bond has until it matures.

Thus far, two factors of corporate bond credit spreads have been identified: credit quality and liquidity. Yet, there are other components behind the narrowing and widening of corporate credit spreads. A third factor is that corporate bonds have a tax disadvantage to Treasury

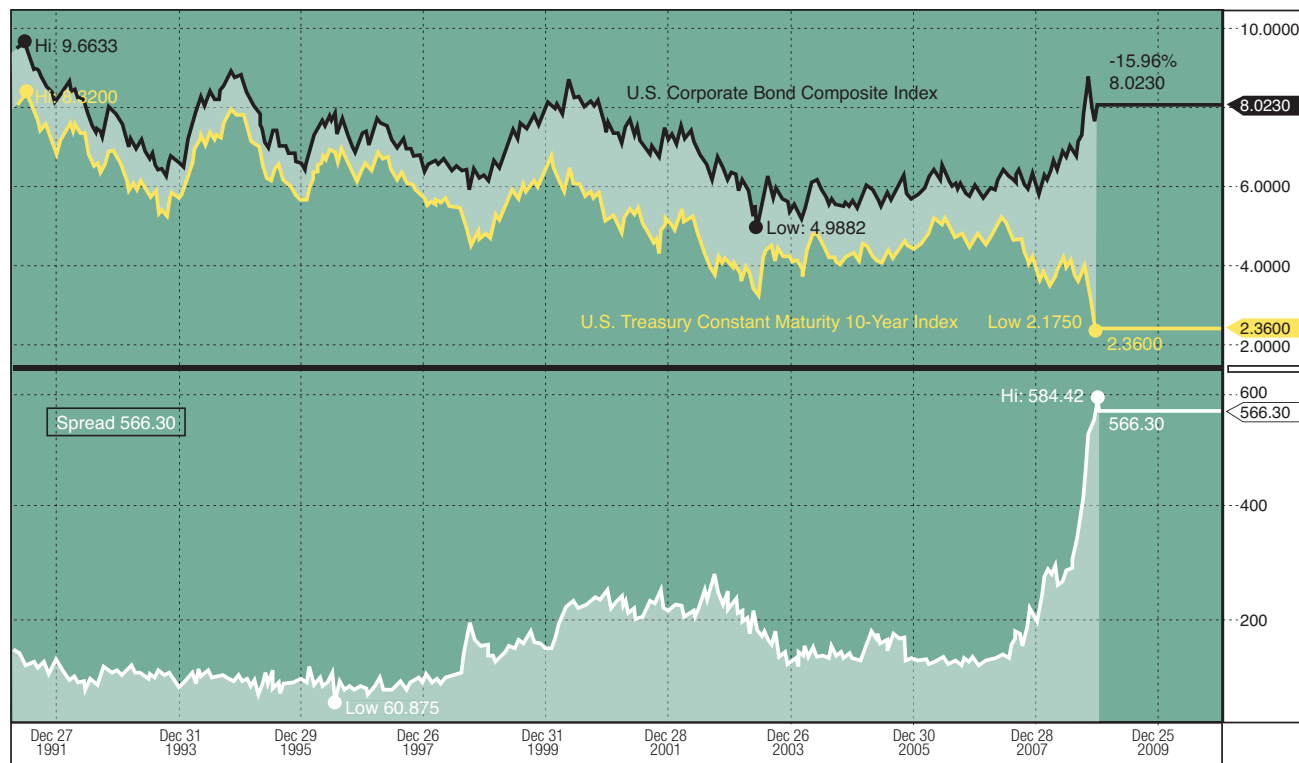
bonds. Interest on a corporate bond is taxed at both the federal and state levels, while a Treasury bond's interest income is taxed solely at the federal level. Due to the tax drawback on owning corporate bonds over Treasury bonds, the yield on a corporate bond in general is higher to balance out the holder's disadvantage.

Another culprit behind credit spread widening is evidenced by defaults tending to happen in patterns. The recent turmoil in the global financial markets is a prime example of this large risk premium. When corporate defaults occur in a domino-like fashion, and when market participants' fear escalates to such a high level indicating that only a default tsunami is expected to come, the market price of risk changes dramatically. So dramatically, in fact, that the chasm in spreads looks like a great white shark opening its jaws just before it feeds. As credit spreads widen, the borrowing costs for riskier corporations increase, making it more difficult to post profits. Combine higher borrowing costs with the economic slowdown, the panic of the domino-effect sets in and credit spreads expand.

As illustrated in the chart on page 5, the spread or yield difference between lower-risk bonds and higher-risk bonds widened to record highs during the later portion of 2008. In the example provided, the lower-risk bonds are represented by the U.S. Treasury Constant Maturity 10-Year Index, and the higher-risk bonds are represented by the U.S. Corporate Bond Composite Index constructed of corporate credits rated BBB and higher. A flight to high quality was made by many investors into lower-risk Treasury bonds, which drove prices up and yields down throughout 2008. The low demand and fear of holding higher-risk corporate bonds caused the yield spread to swell beginning in November 2008, and did not begin to level off until year-end. To illustrate, the yield spread on March 30, 2007, stood at 125 basis points, or 1.25%. This means that if an investor chose to hold investment-grade corporate debt over a

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## CREDIT SPREADS ... continued from page 4



similar 10-year maturity U.S. Treasury bond, he/she would be compensated with 1.25% in additional yield. The yield spread on June 30, 2008, increased to 264 basis points, or 2.64%. In mid-November, the yield spread had widened to 505 basis points, or 5.05%. On January 2, 2009, the yield spread roared to a peak at 584 basis points, or 5.84%. This data shows that investors are and have been reevaluating the yield-to-risk relationship due to recent credit market concerns. Historically, the yield spread has averaged around 2.0%. During the early 1930s the credit spread had expanded beyond 700 basis points.

The current heightened credit spread levels presented an investment opportunity. The extreme credit spread levels are not sustainable over the long-term and actually, in early January, began to slightly narrow.

On January 21, 2008, the 10-year Treasury was yielding 2.36%, and investment-grade corporate bonds were yielding 8.02%. Will future invested money begin to gravitate toward riskier

assets and bring credit spreads back to normalized levels? During the period from November 2008, to January 2009, it looked as though investors had already begun to recognize the opportunity as credit spreads began to slightly contract.

The FIM Group investment Team began to purchase corporate bond closed-end funds back in October 2008. Trading liquidity in corporate bonds dried up, and we felt that corporate bond spreads baked in extremely pessimistic (and unrealistic) scenarios for future corporate defaults. We bought these closed-end funds when corporate bond spreads were nearly 600 basis points over Treasuries, and we expect that this spread will eventually normalize. Whether or not spreads retreat to the 100 basis point levels experienced during 1992-1997 is questionable, but even a pull-back to 500 basis points would likely be very bullish for our closed-end fund positions.

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Investors with at least a three-year time horizon should be well-compensated for having allocated to a diversified grouping of investment-grade corporate bonds. Our purchases since October 2008, of investment-grade corporate bond closed-end funds have been profitable. Our holdings in these types of closed-end funds have benefited from increased investor demand causing the discounts to net asset value to narrow, healthy interest distributions from the underlying holdings, and appreciation in the market value of the underlying holdings.

It is neither expected that corporate bond spreads will revert back to normalized levels in the near-term, nor will I become a marathon runner overnight. These things take time. In the case of corporate bond spreads, those who have patience and understand both the risks and the rewards will be compensated. As for the novice jogger, every time I pump myself up to go out into the below-freezing temperatures, I tell myself I am up for the challenge, and just maybe I'll muse about the next great idea. **F**

Investment Team Briefs (January 29, 2009)

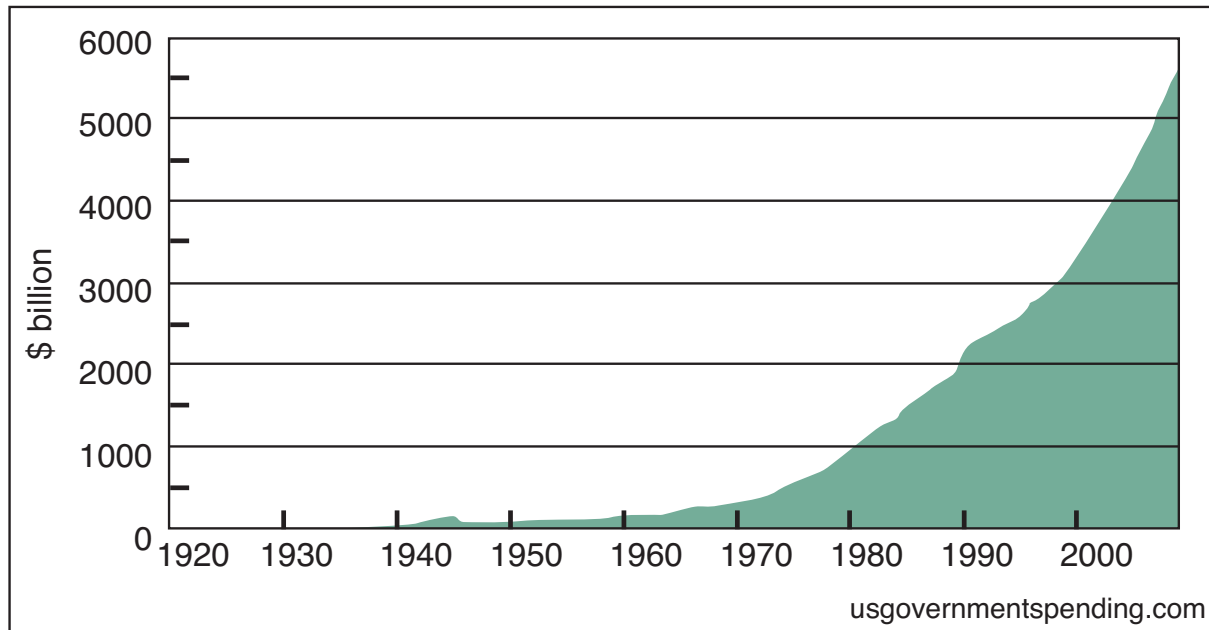


by Zach Liggett, CFA®

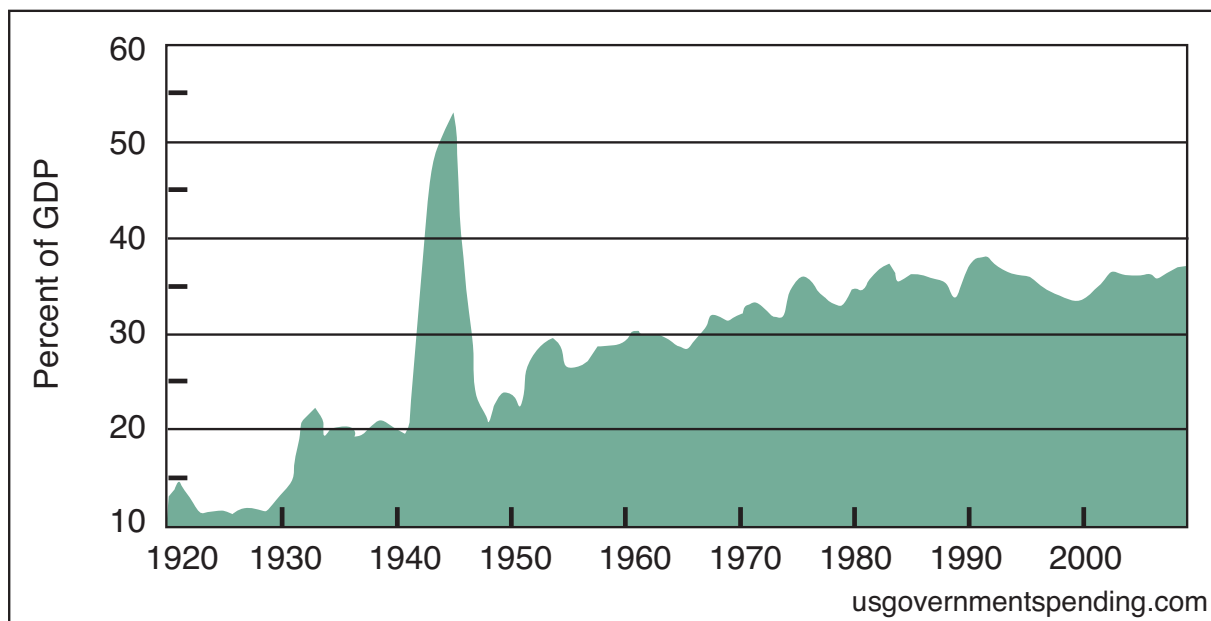
**Item:** With the government bailout mania absorbing headlines today, here's a look at the past 90 years of government spending.

**FIM Group Response:** The charts on page 7 are sourced from *www.usgovernmentspending.com*, a helpful (if not sobering) resource to track the fattening of U.S. government. As investors, we must be wary of this trend as accelerated government spending is ultimately financed by higher taxes, higher borrowing or higher inflation, none of which are particularly helpful for stock or bond markets. Greater government largesse also chokes the real hope for future sustainable economic growth: entrepreneurialism, risk-taking and the power of human innovation. Markets are clearly reacting to the various government stimulus proposals and what they imply for future government growth. Our team continues to work hard structuring portfolios to protect against the probable fattening of U.S. government through investments with built-in inflation protection (for example, Treasury Inflation Protected Securities, stocks of companies with strong competitive positions and pricing power, and foreign securities) and proactive tax-management strategies.

## Government Spending in U.S. – FY 1920 to FY 2009



## Government Spending in U.S. – FY 1920 to FY 2009



## Disclosure

Performance data quoted represents past performance. Past performance does not guarantee future results. All performance assumes reinvestment of dividends and capital gains. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. Performance data current to the most recent month-end may be obtained by calling 231.929.4500.

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