BARRACK YARD ADVISORS

Current Anchors

October 2011

Things Certainly Look Bleak

Equities: 75%, Bonds: 0%, Cash: 25%

A debt-bubble gone bust is not fun. Government debt levels have ballooned and now the markets are head-to-head with a stark reality: an already weak economy is hampered by too much debt.

Politicians are dysfunctional. The investment climate is fearful.

Businesspeople prefer hoarding cash to building factories. Individual and Institutional investors alike crave perceived safety & security: the 30-year T-bond currently yields less than 3%.

"Animal spirits" are sleeping. American stock prices plummeted in Q3 by some 13-14% and are now off nearly 20% from their yearly highs. Most other stock markets in the world did even worse.

In 2008, policy makers believed the entire system could collapse if some "too big to fail" institutions were allowed to go under. Now it's fears of a similar domino effect, but this time it involves certain European nations.

As developed-world politicians have made promises their societies will have difficulty keeping, the resolution to this problem is political and goes a long way in explaining the recent volatility.

So, the optimistic case is that politicians will eventually work things out.

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Gold

Gold can make beautiful jewelry. That's certain. All other uses--as money, as an inflation/deflation hedge, as a long-term investment--are open to wide differences of opinion.

Is gold money? Ron Paul seems to think so but Ben Bernanke says it isn't. Try paying your next heating bill with a gold coin and make your own decision.

Is gold an inflation/deflation hedge? Despite a 6-fold rise in price during the past decade, gold has NOT kept up with the consumer price index since its last price peak of some 30-years ago. But it has done well if you go back 40-years when Nixon took us off the gold standard.

Is gold worthy of long-term investment? Does it belong in your portfolio?

Consider what holding gold is truly about. It's a two-step process.

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And the stock market will eventually reward strong companies that have been building value for shareholders.

Currently many quality companies pay dividends in the 4-5% range.

We advise caution when things look good and optimism when they look bleak.

And things look bleak.

Accordingly, we are moving portfolios to a more fully invested position.

> *"We advise caution when things look good and optimism when they look bleak...and things look bleak."*

We hope to reduce our cash holdings from the 34% level of a few months ago to something more like 15% in the weeks ahead.

We favor "toll-taker," "perpetual annuity," and "store-of-value" themes so long as they pay juicy dividends.

Gold

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First, a company spends large sums taking gold out of the ground; in some cases removing as much as 60,000 tons of rock to produce a ton of gold. In many cases the process despoils the environment.

Second, investors pay a recurring fee to then place the metal back into the ground (a vault). They sit and wait for politicians and policymakers to become even more dysfunctional, hedging against the end of the world as we know it.

At Barrack Yard Advisors, we believe gold is for jewelry, not serious investment because:

- We believe our investments should pay <u>us</u> and not the other way round.
- There are better ways to hedge against uncertainty.
- After a 6-fold rise in prices during a period when the stock market produced essentially no return, we think there'll be a reversion-to-the-mean adjustment in prices.
- We have no basis for knowing what the price should be, beyond the supply/demand dynamics as jewelry. Nor does anyone else.

Can gold prices go higher from here? The average prediction by "experts" at a recent Global Conference says the price will be 25% higher in a year. Some expect a doubling in prices.

Our view: Indian Housewives, the real experts on gold, became net sellers a few years ago in the $900s. Gold at $1,700 has probably entered a stage that can be called "bubble." Bubbles can last a while and prices can go to absurdly high levels.

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Italy

Italy is not Greece because the government is not really broke. Sure they've made too many promises and government debt at 120% of GDP is simply too high if they want to grow the economy, which they must do. But no, they aren't bust--yet.

Italy has world-class companies: ENI, Fiat, Luxottica, Prada, and Pirelli to name a few. As is the case in the United States, non-bank corporations have rarely been as financially strong as today.

Italians are comparably rich, with "average" household net-worth of some $475,000. This household wealth exceeds total national debt by a factor of 4X, according to the Bank of Italy.

But Italy's facing a crisis because its sovereign debt load has come into focus. As with the United States last summer when it lost its Triple-A rating, the ability to pay debts is not so much the issue. What has rattled markets: the willingness of Italy to pay its debt is in question.

Italy, like the US, needs to cut governmental fat, implement structural reforms, and get politicians to stop bickering, and start doing the right thing. No small task.

For a very long time, up until the financial crisis of '08, politicians were nearly irrelevant. Globalization and de-regulation had fostered the “Great Moderation” and other bounties.

But the world has changed. The agenda is now controlled by politics. More now than at any time since at least the 1970s, if not the 1930s, politics matter because only politicians can solve what ails our world. Business is no longer in the driver's seat.

Investors crave stability; so high levels of market volatility reflect a lack of faith in our political system to solve the pressing problems of the day. But common sense says problems eventually do get solved.

Meanwhile, dividend yields on European stocks are higher than the yields on safe government and many corporate bonds. Earnings-based valuations are at a 28% discount to the 40-year average, according to DataStream.
In short, European companies are inexpensive by historical measures.

Admittedly European stocks were cheaper back in March ’09 than they are right now. Otherwise, one needs to go back to recession bottoms in the 1970s and early '80s to find valuations significantly lower than today.

It’s worth noting: when stocks hit those deep recession bottoms in 1973-74 and 1980-82, government bond yields, at 10% plus, were higher than the then current dividend yields on stocks.

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