

Blackhaw Wealth Management Quarterly Letter

A Risky Anecdote, Market Commentary, and A New Investment

By: Ian McAbeer, CFA

A Risky Anecdote

As an investment advisor I spend a considerable amount of time speaking with analysts, investment strategists, bankers, traders, and other industry professionals. I also spend a lot of time talking to clients and others who are not financial professionals, but have a real interest in financial matters because they have capital to invest. It is always interesting to spend time with those in the latter group, because they often have a more pragmatic view of the world, focusing primarily on how they have been impacted by current events, rather than discussing matters in ideological or theoretical terms.

I recently had one such encounter when I was contacted by a gentleman who has saved a considerable amount of money for many years and has diligently invested his savings in FDIC-insured certificates of deposit. No stocks, no bonds, only CDs. This individual, who happens to be nearing retirement, was concerned about the fact that many of his CDs will be maturing soon and the available interest rates for reinvestment of the proceeds will not provide sufficient income for his needs. He called me to explore government-guaranteed alternatives to CDs that would still be able to provide him with a reasonable rate of return. Unfortunately, no such alternatives exist. In today's environment of low interest rates, achieving a 5-6% yield is not possible without exposing one's capital to some form of risk, whether it be interest rates, credit spreads, stock markets, currencies, or otherwise. There is no free lunch here – if a U.S. Treasury yields X%, and some other security yields *more than* X%, the latter security entails some form of incremental risk – period.

My encounter with this gentleman reaffirmed something that I've known for a long time: the Federal Reserve and the U.S. government don't really want people to save money, at least not too much money. Quite the opposite – the government wants us all to *spend* money. Were you to buy a house, car, or major appliance during the past year you might have enjoyed some form of tax credit, tax deduction, rebate, or other incentive for shelling out your cash. Save money, however, and you would have received no such benefits. Instead, you might have taken your capital and placed it in a bank account, which would provide you with a return of zero, or some number very close to zero. Put simply, current government policy rewards consumers and penalizes savers.

The “savers” among us may feel compelled to do what the government wants us to do: shift our investment strategy away from safety, and begin buying something that entails greater risk, such as municipal bonds, mortgage-backed securities, high yield bonds, preferred

stocks, common stocks, or otherwise. This action would serve the Federal Reserve's objectives of inflating asset prices (which reduces leverage ratios) and lowering borrowing costs for home buyers, municipalities, corporations, and so forth. By holding short-term interest rates at zero, the Federal Reserve is compelling savers to accept nothing in return for their capital, or to move away from the comfort zone of guaranteed securities and money market funds, and move into a world of uncertainty and risk.

In the Austrian Business Cycle Theory – a theory at the heart of the Austrian School of Economics - this phenomenon is described as “mal-investment.” When a central monetary authority (i.e., the Fed) maintains artificially low interest rates, investors make bad decisions and do things that they wouldn't otherwise do. Principally, because interest rates are so low, investors and corporations “invest” in securities or projects that do not provide sufficient return, given the risk involved. This is counter to the most basic principle of sound investing: the need to earn an adequate risk-adjusted, after-tax, real rate of return on one's capital.

It is decidedly frustrating to earn a rate of return of zero on one's savings; the allure of higher yields is hard to resist. But losing money is worse. Wealth preservation, not a numerical yield target, should be the starting point of any intelligent investment strategy. Regardless of an investor's general risk tolerance, it is probably wise to be cautious at this point in time and avoid the risk of mal-investment, particularly with respect to certain fixed income securities, where the risk-adjusted return is insufficient.

Market Commentary

Moving on to the markets, in my last communication dated May 25th, I described the five contributing factors to the market volatility and price declines that had developed in global equity markets during late April and continuing into early May. Not a whole lot has changed since then. The Greek crisis remains unresolved, although the initial concerns of default dissipated as Greece was able to stay current on its debt obligations, thanks to the stabilization plan passed by Germany and other EU member states. The 1,000 point intraday decline on the DJIA that occurred on May 26th has faded from memory. The almost unbelievable disaster in the Gulf of Mexico continues, as we all hope that the relief wells are on target and can be used to successfully stop the flow of oil. And the situation on the Korean peninsula has gone nowhere, although it appears that the South intends to avoid any form of military response to the sinking of her naval vessel some months ago.

In my last communication I had the following to say:

“... [I]continue to believe that the global financial system is somewhat more fragile than most would have believed just one month ago, and that the range of possible outcomes for economic growth,

inflation, and financial asset prices is uncomfortably wide. It is likely that the volatility will continue for many months to come, albeit with less directionality than we've seen recently."

This is what we have experienced as equity markets has traded up and down since that time, ending the second quarter with a loss of 11%, based on the S&P 500 Index. Going forward I expect similar behavior, but the balance of risks to global economic growth now appears to be skewed to the downside. The situation in Europe and the continuation of troubling economic data in the U.S. suggests that most developed economies (Canada and Australia excluded) are struggling to achieve sustainable growth. In light of this, we have continued to maintain a relatively conservative posture in client accounts; even our aggressive client accounts contain no more than 55% of total capital invested in common stocks at this point in time, and many client accounts have considerably less.

I expect the second half of 2010 to be a challenging environment, and suspect that we will be rewarded for conservatism, while being opportunistic with investment selection. There are three general areas in which I continue to remain optimistic over the medium term and have invested accordingly: U.S. high yield bonds, developing market bonds, and select emerging market equities. Our client accounts are positioned appropriately in these areas and we have relevant allocations to fund managers who are talented and capable of adding value through security selection and portfolio risk management.

A New Investment

One new investment was made for our client accounts during the quarter - *timberland*. Timberland represents a unique and compelling investment opportunity at this time because it possesses numerous attractive characteristics: it provides inflation protection because the underlying asset is a scarce, physical resource, it provides growth, it provides indirect exposure to emerging economies around the globe, and the particular investments that I have chosen to make are structured to provide our clients with a high level of tax-efficient income.

For the past few years lumber prices in the U.S. have been depressed, primarily as a result of the housing collapse. Secondly, there has been a glut of timber supply from Canada in recent years due to an insect epidemic, which has forced Canadian timber producers to harvest more than normal. Basic economics tell us that higher supply, coupled with lower demand, will always translate into lower prices for a commodity, and consequently lumber prices declined from 2006 through 2008.

Now, both of these variables have largely ceased to depress the market and lumber prices have been steadily appreciating. New home sales in the U.S. are about as low as they can possibly go, having declined by 75% from the peak in 2006. Although some readers may find reason to disagree with me on this point, I am willing to take a stand and propose that the

current level of 450,000 annualized single-family housing starts is unsustainably low – it is far below the long-term production of new housing units that is necessary to absorb the 3 million person increase in the U.S. population that occurs each year. This does not mean that home *prices* have bottomed, only that starts for new housing *units* likely have. Furthermore, it is expected that the Canadian over-supply situation will end within a year's time. Even in the absence of an improvement in the U.S. housing market, the decrease in timber supply from Canada will result in increased demand from domestic timber sources, and it is reasonable to expect a substantial increase in lumber prices going forward.

Over the long-term, global consumption of wood-based products is strongly correlated with two variables: population and wealth. The global population is expected to increase by an additional 1.4b people in the next 20 years, and the emerging economies of the world are experiencing rapid increases in wealth and living standards. As large populations in these developing countries, such as China, increase their per capita wealth, it is reasonable to expect that total wood consumption among emerging economies will increase and approach levels more consistent with developed economies, such as the U.S. and Japan.

Perhaps the most unique aspect of a timberland investment is its organic growth, literally. Regardless of recessions, depressed lumber prices, geopolitical turmoil, or other sources of investment risk, year after year, trees grow bigger. Let's compare this situation to a different commodity: crude oil. If you buy a barrel of oil and hold it for 5 years, you will still only have one barrel of oil. If you buy an acre of timberland and wait for 5 years, you will still only have one acre, but the combined size of all trees living on that acre will have grown measurably, and you will therefore have more *timber* than you originally purchased. The investment grows, biologically, and this enhances investment returns over the long term.

Although there are different ways that investors could seek to gain exposure to timberland, the best way for our clients is through well-managed, publicly-traded, real estate investment trusts ("REITs"). We have chosen to make two such investments and I am very happy with the companies, their management teams, their financial positions, and the quality of their underlying timberland assets. Importantly, because these companies are structured as REITs, they pay no corporate income taxes and instead they distribute at least 90% of their annual income as shareholder dividends. For tax purposes, most of the "dividend" income is actually classified as long-term capital gain, and is therefore taxed at the current rate of 15% - well below the average federal *income tax* rate of our clients. The two particular timberland companies in which we have invested currently pay dividend yields of approximately 5%. Neither company cut their dividends during the recent economic downturn; on the contrary one of the two companies actually *raised* its dividend. Suffice to say, our timberland investments provide very consistent, inflation-protected, tax-efficient income. I expect that these investments will handily outperform the broad equity markets going forward.

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It is important for our clients to understand that the relative success of our timberland investments is not dependent on higher lumber prices or an improvement in the U.S. housing market. Instead, timberland presents a compelling opportunity at this point in time because it entails numerous attractive characteristics, including inflation protection, growth, leverage to emerging market economic development, tax efficiency, and substantial current income. These are all positive attributes for any investment in the current economic environment. Our client accounts now hold 2-4% of their capital in timberland REITs, which are paying tax-efficient dividend yields of greater than 5%, and “growing” every year.

If you have any questions about this letter or anything else related to your investments at Blackhaw Wealth Management, please do not hesitate to contact me.

Ian McAbeer, CFA

President

Blackhaw Wealth Management, LLC

512-425-0535

ian@blackhawwealth.com

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